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U.S. Government Securities:

Expanding Access to Interdealer Brokers' Services

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Transcript of a Hearing Held Jointly by GAO, the Department of the Treasury, the Federal Reserve System, and the Securities and Exchange Commission on February 4, 1987, Washington, D.C.

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PREFACE

On February 4, 1987, a joint public hearing was held by the U.S. General Accounting Office in conjunction with the Department of the Treasury, the Federal Reserve System, and the Securities and Exchange Commission. The hearing fulfilled part of GAO's responsibilities mandated in the Government Securities Act of 1986 (see appendix I for a complete description of the requirements specified in the Act). Various market participants provided their views on whether access to one blind brokering trading system should be expanded and whether the interdealer brokers' quotation information should be made publicly available.

This product includes the transcript of the hearing, the Federal Register Notice of Public Hearing and Request for Comments (appendix I), and the written comments provided by witnesses (appendix II through XI). Due to time constraints and the desire to release the transcript as quickly as possible, neither witnesses nor panelists were given an opportunity to review and edit their remarks. GAO staff did, however, compare the text to the video recording of the hearing to ensure the accuracy of the transcript. The staff also made minor grammatical and punctuation changes to enhance readability. Therefore, this transcript is as close as possible to an actual recording of the comments made during the hearing.

MODERATOR

William J. Anderson	Assistant Comptroller General for General Government Programs, U.S. General Accounting Office

PANEL MEMBERS

Craig A. Simmons	Senior Associate Director, Federal Financial Institutions, U.S. General Accounting Office
William S. Bremner	Deputy Assistant Secretary, Federal Finance, Department of Treasury
Donald L. Kohn	Deputy Staff Director for Monetary and Financial Policy, the Federal Reserve Board
Stephen G. Thieke	Senior Vice President, the Federal Reserve Bank of New York
Richard J. Ketchum	Director, Division of Market Regulation, Securities and Exchange Commission
Brandon Becker	Associate Director, Office of Self-Regulatory Oversight, Division of Market Regulation, Securities and Exchange Commission

TABLE OF CONTENTS

Page

Preface 1

Opening Remarks by Moderator and Panel Members. 5

Statement of Thomas F. X. Mullarkey, Lazard Freres and Company, accompanied by: Peter Roberts, Lazard Freres and Company, and David Todd, Patton, Boggs and Blow 8

Question and Answer Session 12

Secondary Dealers

Statement of Michael G. Stout, First Bank System Capital Markets Group 22

Statement of George Potter Kegler, A. Webster Dougherty and Company, Incorporated 24

Question and Answer Session 28

Non-Dealer Investors

Statement of Bruce Brummitt, Association of School Business Officials, International 43

Statement of Rodger Shay, U.S. League of Savings Institutions. 46

Question and Answer Session 49

Credit Evaluation Practices

Statement of Mark V. Holloway, Goldman Sachs and Company. . . 59

Statement of Paul A. Zintl, J.P. Morgan Securities, Incorporated. 61

Question and Answer Session 66

Brokers

Statement of Lawrence I. Fox, Government Securities Brokers Association, accompanied by: Edward Geng, Fundamental Brokers Institutional Associates Peter H. McKay, RMJ Securities Corporation Michael F. Franzese, MKI Government Brokers, Incorporated. 73

Question and Answer Session 77

Page

Primary Dealers

Statement of Ralph Peters, Discount Corporation 93

Statement of E. Craig Coats, Primary Dealer Committee, Public Securities Association 99

Statement of S. Waite Rawls III, Chemical Bank 104

Question and Answer Session. 105

Appendix

I Federal Register, January 2, 1987, Part IV. General Accounting Office Notice of Public Hearing, Request for Comments on the Nature of the Current Trading System in the Secondary Market for U.S. Government Securities 119

II Comments Submitted by Lazard Freres and Company. . . 127

III Comments Submitted by First Bank System Capital Markets Group. 151

IV Comments Submitted by the Association of School Business Officials, International. 179

V Comments Submitted by Goldman Sachs and Company. . . 193

VI Comments Submitted by the Government Securities Brokers Association. 201

VII Comments Submitted by RMJ Securities Corporation . . 233

VIII Comments Submitted by Fundamental Brokers Institutional Associates 249

IX Comments Submitted by Discount Corporation 263

X Comments Submitted by the Primary Dealer Committee of the Public Securities Association . . . 271

XI Comments Submitted by Chemical Bank. 281

PROCEEDINGS

[10:00 a.m.]

MR. ANDERSON: Good morning, and welcome to today's hearing on the secondary market trading system for government securities. My name is Bill Anderson. I am the Assistant Comptroller General for General Government Programs for the General Accounting Office. I will be the moderator for today's hearing.

The Government Securities Act of 1986 mandated GAO to study the secondary market trading system in government securities to provide information on the availability of quotations and brokers' services. Also, it requires GAO to review whether or not such quotations and services are available on terms consistent with the purposes of the Act. These purposes include the maintenance of fair, honest and efficient markets and the protection of investors.

The Act also requires the GAO, as part of its information gathering process, to conduct at least one joint public hearing with representatives of the Department of the Treasury, the Federal Reserve System and the Securities and Exchange Commission. Representatives of these agencies are on the panel and I would like to introduce them and the GAO representative at this time.

On my right, representing GAO, is Craig Simmons, Senior Associate Director, Federal Financial Institutions. At the far left is William J. Bremner, Deputy Assistant Secretary, Federal Finance, for the Treasury Department. At my immediate left is Richard Ketchum, Director, Division of Market Regulation for the Securities and Exchange Commission. On my right, representing the Federal Reserve System, are Donald Kohn, Deputy Staff Director for Monetary and Financial Policy for the Federal Reserve Board, and Stephen Thieke, Senior Vice President of the Federal Reserve Bank of New York.

I would like at the outset to thank these officials and their staffs for their cooperation and assistance in preparing for these hearings.

The issues on which GAO is seeking comment at today's proceedings were spelled out in a Federal Register Notice of Hearing and Request for Public Comment published on January 2, 1987, copies available on the table. This notice provided a series of questions grouped into three issues.

The first issue, trading access, involves the reasonableness and consequences of interdealer screen brokers limiting their customer base for trading Treasury and Agency securities on their systems to primary and aspiring primary dealers. The second issue, information access, involves the reasonableness and

consequences of brokers' decisions to permit only their customers to view the activity transpiring on their screens.

The third issue, utility of brokering services and quotation practices, raises the question of dealer quotation practices and solicits views on the applicability of practices in other markets that might serve as benchmarks for evaluating practices in the government securities market.

Thus far, we have received a large number of written responses to the notice, including those from witnesses who will testify today. Since panel members and witnesses have had the opportunity to review the written statements submitted by others, we invite witnesses in their opening statements to react to the arguments voiced by others as well. We expect that during the questioning period, the panel members will ensure coverage of the issues addressed in the hearing notice and pinpoint areas of agreement and disagreement.

Before turning to the panel members for any opening comments they may care to make, I would like to offer a couple of other comments of my own. First, the Agency panel members are not here to express their agencies' views on the issues in this release nor to respond to questions. GAO intends to obtain their views through interviews and informal comments on the draft report which will include the results of our study.

Second, only panel members will be permitted to ask questions of the witnesses. Questions will be asked on a round robin basis until all the time has been expended or there are no further questions. We may also ask witnesses to respond in writing to questions which we were not able to ask because of time constraints.

Third, a written transcript of the hearings will be prepared and available for review in the GAO Law Library right over here at 441 G Street, and our New York regional office as well, in about two weeks. Finally, GAO will keep the public comment record open until 5:00 p.m. February 11th, a week from today, so that market participants can respond to any issues raised in the written submission or during the testimony today.

I have two other GAO officials here today who may be submitting questions from time to time in support of Craig Simmons, who is the principal GAO person here: Steve Swaim -- hold your hand up -- and Paul Zacharias. They have been working for Craig and are the leaders in GAO's work in this area.

With no further ado, let me turn it to Craig first for any comments he may want to make.

MR. SIMMONS: I don't have any formal comments. Let me just say good morning to everybody. We have got an awful lot of ground to cover today. I am looking forward to hearing from the witnesses and trying to focus on what the major areas of disagreement are and what areas associated with the secondary broker system, don't seem to be in much contention. I hope, if nothing else, we can accomplish that and also develop a bit more in the way of specific information on the effects of the access issue on market liquidity and efficiency. If we are going to consider access seriously, by what mechanism should we establish credit standards; who should do the monitoring; what kind of monitoring should it be if we are going to seriously consider access?

Finally, I would like to develop as much specific information as we can from the dealer community and from the investor community on precisely what kind of information they feel is lacking currently in the market.

MR. ANDERSON: Thank you, Craig. Mr. Thieke?

MR. THIEKE: I just would echo Craig's comments about how pleased we are to be here to have an opportunity to participate in this hearing and to collect the views of different segments of market participants on the types of issues that the GAO has raised in its request for public comment, and particularly interested to hear how they regard the public policy aspects of those issues, if they can draw these distinctions, as opposed to those issues that are important to them from the private competitive point of view.

MR. ANDERSON: Thank you. Mr. Kohn?

MR. KOHN: I have nothing to add, Bill. I appreciate the opportunity to be here and look forward to an interesting session. Thank you.

MR. ANDERSON: Thank you. Mr. Bremner?

MR. BREMNER: Like other members of the panel, I appreciate the opportunity to hear your comments. On a related issue, I hope those of you who are market participants have left the proper people behind in your office to bid on today's note auction. I have no further comments.

MR. ANDERSON: Thank you. Mr. Ketchum?

MR. KETCHUM: Mr. Anderson, the SEC appreciates the opportunity to participate in this hearing. I think we found the written comments to have been thoughtful and very helpful, and we look forward to getting additional details and explanations of the markets and how they operate throughout

today. I would just mention that at times during the day my associate director, Brandon Becker, will fill in for me and also may be asking some questions with respect to this hearing.

MR. ANDERSON: Thank you very much. I would like to invite our first panel to the table, Mr. Thomas F.X. Mullarkey, partner, Lazard Freres and Company. Will you please come forward, sir? He will be joined by Peter Roberts, also of Lazard, and David Todd of Patton, Boggs and Blow, counsel to Lazard.

Gentlemen, welcome. Proceed as you will.

STATEMENT OF THOMAS F.X. MULLARKEY, PARTNER, LAZARD FRERES AND COMPANY, ACCOMPANIED BY PETER ROBERTS, LAZARD FRERES AND COMPANY, AND DAVID TODD, PATTON, BOGGS AND BLOW

MR. MULLARKEY: My name is Tom Mullarkey and I am, as you stated, a partner in Lazard, and I am accompanied by Peter Roberts, on my right, and David Todd of the Patton, Boggs and Blow firm on my left.

Lazard is a registered broker-dealer as well as one of the Federal Reserve's monthly reporting dealers. In addition to that, we are a dealer in government and agency securities. We are a market maker in corporate debt and in equity and municipal securities. We serve a broad range of clients ranging from government to individuals. We are subject to the regulatory oversight of the Securities and Exchange Commission as well as the major exchanges, the NASD and so forth.

We have, as you have pointed out, Mr. Chairman, submitted written comments in response to the GAO's request, and in those comments we expressed our views on the current exclusionary system of trading in the secondary market for government securities and addressed the particular questions raised by the GAO.

It is clear from the background statement and the specific questions posed that the GAO and the panel are conversant with access, with the government securities market and the limiting of broker access in the secondary market to primary dealers or those referred to as aspiring primary dealers.

Lazard has been urging a reform of the current system of arbitrary limitation of access to trading in the secondary markets for a considerable period of time. Although we believe we have the financial resources and knowhow to become a primary dealer, we have chosen not to have a direct business relationship with the Federal Reserve for our own strategic business reasons, which are in no way antithetical to making markets in government securities. Indeed, we are committed to do so.

The linchpin of our thesis is that whether a dealer is or is not a primary dealer is irrelevant to the secondary market and has no legitimate bearing on access to the broker trading system. We submit that all qualified dealers in the secondary market should have complete trading access to permit competition on a fair and equal basis.

The current system gives a significant and entirely unjustifiable advantage to the primary dealers in trading government securities. It is that of their own making. A member of Congress and one of the parties submitting comments to you gentlemen have well characterized the current system as an oligopoly. The arbitrary limitation of trading access, with its thinly-veiled standards of financial suitably, should simply no longer be tolerated. We trust and certainly hope that the GAO's report to Congress will act as a catalyst to reform this system.

In its government trading, Lazard must compete with primary dealers who have inside price information and the ability to trade quickly at those prices. This has caused and continues to cause Lazard and others in our position significant losses. This is, of course, what has motivated our continuing efforts to reform the system.

At one time not so long ago those who defended the status quo argued that exclusion from the broker screens and direct trading was relatively inconsequential. The written comments, however, submitted to you have ended any such contention. Many, including the Primary Dealers Committee of the Public Securities Association, have emphasized the importance of blind brokering, and by doing so have, at least in the case of the primary dealers, unwittingly emphasized the harm to those excluded from the system.

The statements by excluded dealers and the brokers themselves are even more forthright about the disadvantages of being denied access to trading through the brokers. The primary dealers state, "Without anonymity, dealers both primary and non-primary would be able to determine current positions of other dealers in particular issues and would adjust their trading strategies accordingly." This is one of the difficulties we face and others in our position because we must often use a primary dealer with whom we are in competition instead of effectuating blind trades through the brokers.

Despite this candid admission by the Primary Dealers Committee, some of the individual primary dealers have submitted comments seeking to minimize the competitive disadvantage of being denied access to the screens. This simply will not wash, as is made evident by a review of their statements. Indeed, the very tenacity with which the primary dealers seek to preserve

their monopoly demonstrates beyond a doubt the considerable competitive advantage they now enjoy.

Primary dealers contend that because Cantor Fitzgerald allows access to non-primary dealers and also disseminates market information via Telerate, that the public interest and the need for information is adequately served. On the contrary, the very existence and successful function of Cantor shows that there is no need to limit access to the primary dealers. However, because Cantor covers only a small portion of the market and does not provide trading in all parts of the market, it does not act as a substitute for access to the brokers.

The primary dealers use Cantor Fitzgerald only when they have to because particular trades are not otherwise available, and it is, therefore, not a complete or accurate mirror of the market. The Telerate system is subject to the same limitation: namely, the public does not get price information on the full market.

Sweep aside for the moment our own enlightened self-interest. Let's deal with the public's interest in reforming this system. The principal concern of the agencies represented by your panel must deal with the effect of exclusionary practices upon the public interest. We contend that a free market will increase in depth, breadth and resiliency, with the ultimate result of better prices and a lowering of the cost of financing the government's debt.

Strangely enough, the brokers now agree. The submission of the Government Securities Brokers Association states, "Expanding the number of participants in the system, while maintaining efficient markets, would likely increase the depth of the market in each government issue and reduce the price spread on such issues. This would decrease price volatility, enhance investor confidence, and improve the ability of the government to fund its debt." We could not have said it better.

The primary dealers contend that the practice of limiting access originates with the brokers themselves based on an assessment of business and credit risks. Quite a different picture emerges from the statement of the Brokers Association, which makes it clear that the impetus for maintaining the current system is primarily the fear that the primary dealers would no longer use their services. Thus, we now have a distorted, restricted system which serves well the financial interests of the primary dealers but causes severe harm to the market as a whole. The public, we submit, is the ultimate victim.

Although the brokers generally seem to recognize the need to open up the system and increase market liquidity that broader

access would bring, they have expressed concerns that the primary dealers might withdraw if their monopoly were ended.

Our reply to this is simple. In the real world, if the system of blind brokering is anywhere close to being as important as the primary dealers themselves have portrayed it to be, they will not withdraw from the system. On the contrary, we submit the system would be strengthened.

Devising an acceptable means of assuring the integrity of dealers is not nearly as formidable a task as has been painted. First, the Federal Reserve's primary dealer system does not offer nearly the degree of safety as those defending the status quo contend.

The primary dealers list was never intended as an insurance of financial integrity or general creditworthiness, as the Federal Reserve itself has emphasized. The fact is, from time to time, the Federal Reserve has suspended particular primary dealers because of concerns about their positions, but has kept this information confidential.

We submit it is not terribly complicated to devise appropriate standards for access to brokers. Just as an example, we have the National Association of Securities Dealers which serves as a model for limiting trading to acceptable dealers. No other financial instruments' trading system has opted to arbitrarily exclude all but a given class of dealers for reasons wholly unrelated to financial resources and general suitability.

Treasury itself now has the opportunity to issue rules under the Government Securities Act of 1986 which would preclude brokers from continuing to discriminate unfairly between primary and non-primary dealers.

In summary, we believe there are a number of conclusions that can be reasonably drawn.

There is no need to disturb the current relationship between the Federal Reserve and the primary dealers. We don't believe that is at issue. The Federal Reserve can and should be permitted to establish and maintain reasonable criteria for becoming a primary dealer. However, it is the misuse of this system to limit access in the secondary market that should be reformed.

The limitation of access to primary dealers is a result which was never intended by the Federal Reserve and which has no rationale. All parties concede that there are dealers who are fully creditworthy who are not primary dealers.

The current system of restricting access is a serious detriment to non-primary dealers, putting them at a considerable competitive disadvantage.

And, lastly, there are indeed alternative means available to ensure that only dealers of integrity and creditworthiness are allowed to trade through the broker system. As a number of parties have suggested, the regulations to be issued by the Department of the Treasury under the Government Securities Act offer such an opportunity.

Speaking about opportunities, I wish to thank you for myself and on behalf of my colleagues for this opportunity to come before you.

[See appendix II for the statement of Mr. Mullarkey on behalf of Lazard Freres.]

MR. ANDERSON: Thank you very much, Mr. Mullarkey. We'll turn to Mr. Simmons first for any questions he may have.

MR. SIMMONS: Mr. Mullarkey, I'm trying to get a better handle on just how much of an increase in market liquidity and efficiency might result from expanding access. And with that in mind, can you give me anything in the way of specifics on how many non-primary and non-aspiring dealers feel the same way you do about the access issue and what their volume of business is?

MR. ROBERTS: Mr. Simmons, my name is Peter Roberts. I am a partner at Lazard Freres.

I think that question could best be answered by Cantor Fitzgerald who serves 200 dealers, both primary and non-primary and has a better finger on the pulse of their need for access to the market.

We believe in the last 30 years that the Federal debt has increased at a double digit rate, but the number of primary dealers has only increased fourfold. We believe that a tremendous amount of trading is being funneled through a choked-down conduit in the secondary market.

We believe a broadening of the secondary market will bring a lower cost of debt to the U.S. Treasury and increase innovation, and the public will be served better.

MR. SIMMONS: It is my understanding that Cantor does roughly 10 percent of the business in the market. In some segments they do maybe as much as 20 percent. And Cantor does do business with primaries and non-primaries institutional investors, et cetera, et cetera. I don't know exactly how much of that market involves non-primaries and non-aspiring dealers

that feel as you do -- what I'm trying to figure out is are we talking about five firms, ten firms, 15 firms? Are we talking about enough firms desiring access where we might see an appreciable increase in market liquidity and market efficiency?

MR. ROBERTS: Mr. Simmons, Cantor Fitzgerald does not broker the full constellation of U.S. government and agency products. For instance, they do not broker mortgage-backed securities. They do not broker the U.S. Treasury strip program, in which Lazard was a leader and innovator.

We believe that many dealers shy away from the market because they have to assume the extra risk of not having access to the entire market. So we believe that the numbers will increase vastly in participation in the market.

MR. ANDERSON: Mr. Thieke?

MR. THIEKE: Thank you very much.

I just wonder if you could amplify a bit on your observations in your letter and in your opening statement about where you consider the salient features in other markets that exist to work to ensure, as you put it, the integrity and the reliability of dealer participants that you think might have some application to the Government securities markets.

MR. MULLARKEY: Well, if I may, I'll take a crack at that, and I'd also like David to address that question.

There exists today a whole panoply of regulations, as you know. And we have, just as an example, the Federal Reserve's voluntary guidelines on capital adequacy. Those basically track the rules emanating from the Securities Exchange Act of 1934, the 15(c)(3) rules, which provide a whole constellation of regulations to keep a dealer liquid so that he will not over position himself.

When I buy the stock in my firm, when I take an underwriting commitment, I have to have the capital to support that and every position I take. It's what we call "haircutted," as you know.

The Federal guidelines on voluntary capital adequacy are derived from those rules. This is not reinventing the wheel. We have the basic structure there. Everybody in his commercial concourse makes value judgments each day with whom they deal.

The brokers tell us that they make a business judgment on who they let have the screens. Well, I suggest we take them at their face value. We all make these judgments every day. Who to do business with and who not to do business with.

Just as another example, a firm registered just with the Securities & Exchange Commission must file weekly and monthly reports, subject to all kinds of audits, and the consequence of violating the capital rules are very severe indeed. Very severe.

I don't want anybody to go away with the illusion that a regulatory framework upon which we can draw does not exist. It does. The Federal Reserve's daily reporting has its genesis in statistical analysis. It is not a credit watch. And, indeed, we will find if we look at the ratings in Moody's that the primary dealers themselves run the whole gamut in ratings from very low ratings to very high ratings.

I would suggest, based on the prudent man rule, that some of those institutions with the very low ratings -- and they are honorable institutions -- you would not deal with. So, I just think that we have some illusions that are floating around here that really are misconceptions.

David, if you would like to answer that.

MR. TODD: Well, only to say that one of the hallmarks of the regulatory system has, in the financial area, running the gamut from commodities to securities to bonds, has been a great deal of self regulation.

Lazard is not suggesting that there is any need to change that fundamental approach. They do feel that there is apparently a need to step in and say, "In this self-regulatory mode, you can make reasonable business judgments, but they must be fair and they must allow some equal access."

I don't believe that Lazard has any fundamental problem with the brokers themselves doing much of the monitoring that would be necessary, and which we submit they have to do right now, in any event, in carrying out their responsibilities. But they should not be able to simply refer to a list which simply is not an appropriate basis for determining who they will and will not allow to have access to trading with them.

MR. ANDERSON: Mr. Thieke, I'll say this for the benefit of all the panelists, if there is a closely related follow-up question that really needs to be put at that time, please feel free to make it. Mr. Kohn?

MR. KOHN: Thank you. I would like to ask a question which I think does follow up on Steve's question, to some extent, and on your testimony.

Precisely what steps, or as precise as you can be, do you think need to be taken either by the agencies up here, Congress, or in the market to achieve your goals -- which I take it is

opening up access without in any case or any way reducing the benefits from the blind brokering system as it exists. Precisely what would you have who do when?

MR. TODD: Legally the Government Securities Act provides ample authority to Treasury to issue a regulation which would simply preclude brokers from further making unreasonably discriminatory judgments between customers.

The Act in its purpose has as one of its purposes the maintenance of fair, honest and liquid markets in government securities. Under the regulatory part of the Treasury, the government securities brokers are clearly covered. The rules to be promulgated by Treasury should be designed to protect the integrity, liquidity, and efficiency of the markets.

And, again, it is worth noting here that the brokers themselves state quite forthrightly that increasing market participants would increase the liquidity of the market.

Also these rules should be designed to preclude unfair discrimination between customers of government securities brokers or government securities dealers. We believe the Act provides the Treasury with full authority.

The precise step that needs to be taken need is for Treasury to issue regulations which would preclude brokers from arbitrarily denying access to trading on their screens.

MR. ANDERSON: Mr. Bremner?

MR. BREMNER: Regarding the inclusion of additional participants, would you elaborate on the extent of expanding the system? By that I mean expanding to include what additional participants.

MR. MULLARKEY: As we just stated, the brokers now say that they make the judgments on who will have access to their screens. And our response is let's take that at its face value. We're glad that that is the case.

We believe that anybody who has a standing interest in the government market, who has the capital resources to pursue that interest, thereby having a commitment, should be allowed access to those screens.

This, gentlemen, is the only market in the world that has this exclusion. There is nothing mystical about this market. It's very large. But in no sense is it different from the corporate bond market. Is it different from the stock exchanges? What is the mystique about it? There is none. This is an aberration which arose several years ago and has persisted

because, quite frankly, it's a very good deal. But there is a whole constellation of regulations under which one must operate prudently to stay in business.

I believe that you shouldn't have an irrelevant criterion determining who has access to those vital screens. The cornerstone,the linchpin of that, I believe, emanates from Rule 15(c)(3) of the Securities Exchange Act which the Federal Reserve has drawn on. So that can really form the basis of who is entitled to participate.

I hope I've answered your question. I hope I'm not too long.

MR. BREMNER: Your intended expansion then is still restricted to the dealer community, not market participants in general?

MR. MULLARKEY: That's correct.

MR. TODD: If I may make just one statement. The expansion of trading access, yes, but Lazard has made it clear in its written comments that it believes that market information should be made available to all who want it, that the system which now doesn't even allow one to know what the market is should be ended, but that obviously in order to trade in a blind system, there needs to be something more, but there is no basis for limiting access to the market information, so that all who have an interest may have it.

MR. ANDERSON: Thank you. Mr. Ketchum?

MR. KETCHUM: I'd like to pursue your analogy with 15(c)(3)-1 and the Commission's net capital rule because I think it is interesting.

I think you probably agree with me that really when you look to credit assurance in the equity side of the market or corporate bond side, there is really two steps to that. The first step being assurance of financial responsibility through those rules and SEC and New York Stock Exchange examinations. The second step being that when you settle trades, you settle them through a clearing agency that has financial standards dealing with clearing firms. Clearing agencies also look at creditworthiness and take a second perhaps more specific look at the creditworthiness of particular persons and provide more specific monitoring of that activity than can any rule.

I guess my question is, can the brokers be that second step? If so, what is appropriate and appropriate under a competitive system for them to do, given the size of the Government securities market? Do you have objections with large capital

requirements, fundamental basic capital requirements? Forget whether they meet the capital rule. Do you have objections with an analysis of leverage in a particular firm and determinations to limit business if the broker feels that leverage is appropriate?

The follow-up on that is, should the Treasury Department or anyone else regulating that market be concerned with what standards brokers have? The Commission approves clearing agency rules and determines whether or not they ensure a safe and sound system.

Should there be some kind of control with respect to brokers' brokers, if they are going to be asked to go into that analysis?

MR. ROBERTS: In the dynamic free functioning market, although regulation is helpful, it is the market participants policing themselves that is going to create the ultimate standards. All primary dealers are not the same as all non-primary dealers are not the same.

The broker has to use his judgment in performing his service to all participants, primary or non-primary. There is a big difference between a small primary dealer and a very large one. The broker cannot give carte blanche to any dealer, just because he is on the primary dealer list.

MR. MULLARKEY: I think what we are saying, Mr. Ketchum, is that these judgments, which you are asking about, are already exercised. As you well know, the list comprises very large powerful firms and some smaller ones. I assume that the broker makes those judgments now as to how big. We make those judgments in our every day commercial life. We do it all the time. There is nothing unique about this.

MR. KETCHUM: If I could just follow-up. There are two models. There have consistently been concerns about the need, given the size of settlement positions in Government securities, to have very substantial firms involved. Would you view it appropriate if the brokers set very high fundamental capital standards substantially above 15(c)(3)-1 or the Fed's guidelines and said you need "x" amount of capital before we are going to permit you in this system? How much addition to this system do you feel is necessary before it is rational and doesn't have an anti-competitive impact?

MR. ROBERTS: Mr. Ketchum, I think it is a matter of degree. The broker has to set limitations depending on capital standards. A dealer with ten times more capital than another will of course have greater trading limits. It is a matter of degree.

MR. KETCHUM: But you would include both in?

MR. ROBERTS: Yes.

MR. ANDERSON: We will start the second round now with Mr. Simmons.

MR. SIMMONS: Mr. Mullarkey, your submission indicates your view that there is no legal impediment to the release of information by the brokers. I'd like to know why you feel that way. That's the first part of the question.

The second part of the question is, after having addressed the first part, can you help me with precisely what kind of information you believe ought to be released or sold to those who are willing to buy it, by the brokers, assuming they have the legal right to sell it?

MR. TODD: As has been pointed out in some of the comments, some claim that this is proprietary information and cannot be released. It seems to me it is a strange position. I can't offer you a legal brief this morning on the issue but I do know that Cantor-Fitzgerald is releasing the information and certainly has no difficulty in so doing.

To answer the second question, and I might be corrected by my colleagues, but the answer is everything. I'm not like one of the primary dealers who seem to feel that the public might be misled if they were told too much. It is our belief that the public interest would be well served if the public knows as much as they can and we see no reason why all market quotes shouldn't be released to anyone who is willing to pay the cost of getting that information.

MR. SIMMONS: Let me follow up just briefly. Do you think there would be less of a legal problem releasing sale information as opposed to bid and ask information?

MR. TODD: When you say releasing sale information, do you mean --

MR. SIMMONS: Transactions' information.

MR. TODD: I would think so, but again, I can't offer you a detailed brief this morning on that issue.

MR. ROBERTS: Bid and ask information is available in the over-the-counter stock market. You can get it on Quotron.

MR. ANDERSON: Mr. Thieke?

MR. THIEKE: Your comments and responses to earlier questions seem to imply that you see it as primarily the responsibility of the broker to satisfy themselves as to the capital adequacy and other indications of financial strength of the various institutions that are utilizing its services. With what degree of frequency and what mechanisms do you think brokers ought to use to, in effect, continue to satisfy themselves on that basis, and what mechanisms should parties that are trading with brokers use to satisfy themselves that the brokers themselves are adequately capitalized and financially sound?

MR. MULLARKEY: As to the former, sir, if I understand it correctly, the brokers do indeed perform this function now. This is a function which indeed all institutions perform. It comes under the doctrine of prudence, know your customer. This is nothing new. Obviously, the positions that a Citibank or a Salomon Brothers is going to be able to trade through a broker is not the same as somebody at the lower end of the spectrum.

Now, we must assume that the broker is making that value judgment already. He has his own credit infrastructure,as we do. We do it every day. There is nothing new about that. There is a massive amount of reporting so that you can make these judgments, as you know. I mean banks, even the former institutions here were unregulated, and under this Act they will now have to report. The information is there.

I don't think a broker could stand up and say he is going to be a black box. They are not black boxes. We shouldn't assume they are not making these judgments at this very moment. They have to be.

MR. ANDERSON: Mr. Kohn?

MR. KOHN: In an expanded system, would there be need for additional Government oversight of the brokers' judgments? That is in the markets, the other markets, as I think Mr. Ketchum said, the clearing agents must submit rules of financial stability and responsibility often to their SROs and through that, the SEC or the CFTC. There are margins in many of these markets. Would something like this become necessary in an expanded access Government securities market?

MR. MULLARKEY: I am going to defer to David Todd on that, but I see no reason why the brokers who perform this vital intermediary function should not be subject to suitability requirements as indeed anybody who is an agent for counter parties in the commercial markets today, who is subject to some form of regulation. You don't entrust your stock portfolio to your broker without knowing he certainly has to answer to the authorities on matters of prudence and integrity and so forth.

MR. ROBERTS: We also believe that the Federal Reserve and the Treasury can get the best instantaneous glimpse of the market by seeing what is trafficked through a broker. If they are monitoring the brokers, they are going to get a good idea of what is happening in the market, whether it is to effect monetary policy, to effect fiscal policy, or just get a glimpse of exposure in the market.

MR. TODD: I would say that has already been crossed, despite opposition, as everyone on this Panel well knows, from a variety of sources, both private and governmental. This Act was passed. What was previously a fundamentally unregulated market, come July, will be one that is regulated. I think it is inescapable that in a system of expanded access, yes, there will need to be some Government oversight role. I think there will need to be a Government oversight role even if there is not expanded access. The real tragedy would be for this Act, passed for us now, to have regulation which permits the continuation of a blatantly discriminatory system.

The simple answer is yes, there will have to be a little more Government regulation.

MR. ANDERSON: Mr. Bremner?

MR. BREMNER: Without addressing some of the other criteria that are indicated as used in determining who the brokers deal with, among the points that have been raised is in the credit area. In your comments, there is an indication that non-primary dealers at the present time may need to do business with other dealers who they feel are less creditworthy than they are. I guess I have two questions.

Why would one need to do business with someone who was less creditworthy than they were comfortable with, and to the extent that there is a concern about the creditworthiness of the participants, wouldn't involvement in that process tend to complicate that?

MR. ROBERTS: Because we are not afforded the same anonymity that a primary dealer has, by being able to deal on a blind basis in the entire spectrum of Treasury and Agency securities, often times, even with that set-back, to maximize our anonymity, we will use often times non-active primary dealers to effect our trades. Sometimes those dealers do not have the same credit standards as we are accustomed to.

MR. ANDERSON: Mr. Ketchum?

MR. KETCHUM: As was mentioned earlier, you took the position in your written comments that the quotation and transaction information resulting from brokers' brokers activity

should be publicly available on, I gather, a real time basis. A number of commentators raised concerns about that, that the quotation information at least might be misleading because it reflected a large wholesale market price and might not reflect the price that institutions or at least some portion of the persons who would see the information would be able to access. Could you comment a little more specifically on why you don't think that's true?

MR. MULLARKEY: I thought it was a very elitist remark in the first place. I don't think the public is that unsophisticated not to be able to handle the real time quotations. We have it in every other market. I think the empirical data is there. Obviously, a share of stock will trade slightly differently if you are going to trade 100 shares as to 100,000. I mean, that's part of the dynamics, inherent of the market itself.

I saw that view expressed. I don't agree with it because I don't think the empirical data is there to support it and I think the empirical data supports just the contrary, because it does exist in other markets. The misconceptions are not there.

MR. ANDERSON: Mr. Swaim? Mr. Zacharias? Do you have any questions that you would care to pose?

MR. SWAIM: One of the primary dealer standards has to do with making markets in the secondary market -- standing ready to make markets in good times and bad. I wonder if you would comment, first, on the effectiveness you think this standard does have in the marketplace, and, second, the relevance of that standard to access to the blind broker system?

MR. ROBERTS: The standard of standing and making markets is an extremely loose standard, which no quantifiable measures or very few quantifiable measures have been put forth. Lazard stands and makes markets in segments of the Government and Agency markets. As long as the dealer is creditworthy and does the volume to make it profitable for the broker to deal with him, he should have access.

MR. SWAIM: Are you saying that there is nothing special about a dealer standing up and saying to the Federal Reserve, as a matter of public interest, I stand ready to do this? Does that action have no important bearing on the liquidity that characterizes the Government securities market?

MR. ROBERTS: No. We believe that the dynamics of the free market will make certain participants make markets, because that is their business and they can make a profit in doing so.

MR. ANDERSON: Mr. Mullarkey, Mr. Roberts, Mr. Todd, thank you very much, gentlemen. You have been very helpful. Thank you.

Before we proceed with the next panel, I should point out to you that the clock on the wall is wrong. It is five minutes fast by my accurate time. Don't look to it for guidance.

In any event, I would also like to inquire whether the people in the back of the room can hear all the witnesses. Are all the mikes here working properly?

I would like to call now our next Panel. We have chosen two secondary dealers and we will have Mr. Michael G. Stout, Executive Vice President, First Bank System Capital Markets Group; Mr. George Potter Kegler, Senior Vice President, A. Webster Dougherty & Co.

Thank you for joining us today, gentlemen, and we will start with Mr. Stout.

STATEMENT OF MICHAEL G. STOUT, EXECUTIVE VICE PRESIDENT, FIRST BANK SYSTEM CAPITAL MARKETS GROUP

MR. STOUT: Good morning. FBS Capital Markets Group is a division of First Bank System. We are the 15th largest bank holding company in the United States. We are located in Minneapolis, Minnesota. We are secondary dealers in U.S. Treasuries, Money Market securities, and all other bank eligible paper. Our customer base is mainly banks, savings and loan and other fiduciaries in the Northwestern part of the United States. We have a retail based business and we also execute for our own holding companies. We are members of the Dealer Bank Association and the Public Securities Association.

In discussion with my colleagues last night on the plane on the things to talk about, it became clear to us after reading the other comments, that there was some disagreement as to the definition of terms being used in the different commentaries. For our purposes, we thought it was helpful to sit down and go through the four terms that we thought were misleading, used in different ways, or used with an aura of mystique surrounding them.

The first is the notion of market making. It has been our experience that market making is based upon the most interested parties' economic needs to do a trade. Simply stated, that means when one asks a primary dealer for a market in a security, the dealer looks to the primary brokers' screens, where he will see a picture in the security. That picture has been put there either by a final user of Treasury securities or by a dealer acting on the behalf of a final user, or by a dealer who has a position.

The whole idea of making a market in a vacuum is a complete misnomer. One makes a market based upon the real interested parties' need to do the economic trade.

The second thing, limited access blind brokering was referred to in most of the commentaries as the same thing, one and the same. We think they are two separate issues. Every commentary we read indicated that blind brokering was the necessary ingredient to an efficient market. The real bone of contention here is limited access. We think it is a mistake to lump the two together and assume they are one.

Thirdly, auction participation, or the primary market, as it is termed -- another instance here where we thought the term was used rather loosely. Dealers do not bid for auctions in a vacuum. They bid based upon final user demand or the lack thereof. It is a mistake to think of dealer participation as a process separate from the final user of these securities.

Monetary policy implementation. Like auction participation, this process is not separate from the demand or the ownership of securities by the final user, but based on it. People who submit bids for securities or offerings for securities in the Federal Reserve are either primary dealers with their own positions, secondary dealers with their positions through primary dealers, or final users showing their securities through primary dealers.

Some general comments that I would like to make. Executing trades through a primary dealer is tantamount to executing stocks without the benefit of the broad tape. There is no way to objectively verify price or volume information. The Chicago Mercantile Exchange, the Chicago Board of Trade, the New York Stock Exchange, all provide price and volume verification. Arguments to restrict viewing access to either the broad tape or future screens would hardly be accepted by the public as in its own interest.

Secondly, blind brokering. All who commented on blind brokering valued it highly. All stated it was a necessary ingredient to an efficient and fair market. Given it is so highly valued, why is it reserved for the few?

Thirdly, blind brokering creditworthiness. We feel that the primary dealer status need not be the sole guide to creditworthiness. There are many other standards, many other regulatory agencies. In our own case, we deal with the OCC, we deal with the MSRB, other broker dealers deal with the NASD, there are other agencies that do provide guidelines for what is acceptable and non-acceptable practices and what is acceptable capital requirements.

Fourth, in the futures market, it is generally accepted that more participants are better than less. In fact, when a new contract starts in the Exchange, it is of paramount importance to gain more traders in the pit to make that futures contract successful. No one we know of would argue that those pits would be more efficient and more effective with less participants. However, it is being argued that in the Government securities market, less participants are more valued than more. We don't understand this.

Fifth, the public interest and free markets we believe are best served by more information rather than less. Economic theory would tell you that perfect information dissemination is necessary to a free market. We believe this is so.

Finally, economic textbooks will tell you that barriers to entry suggest oligopoly is present. We do not find the barriers to entry that have been raised to be in the public interest. The only barrier to entry that we could think of that was in the public interest in this particular market was the barrier of creditworthiness, and as we have stated, we think there are much more acceptable, much more stringent and perhaps more fair ways of measuring that.

Thank you.

MR. ANDERSON: Thank you, Mr. Stout. Mr. Kegler?

[See appendix III for the written statement of Mr. Stout.]

STATEMENT OF GEORGE POTTER KEGLER, SENIOR VICE PRESIDENT, A. WEBSTER DOUGHERTY & CO., INC.

MR. KEGLER: Good morning. I am honored to have been asked to express my opinions for public policy consideration relating to the access practices affecting the interdealer brokers. I will address the questions of trading and information access only in my presentation here; trading access first.

Blind brokering currently represents approximately 50 percent of primary dealer trading volume, which indicates that this system of trading has been and will continue to be an important gauge of its measure of efficiency and value to market liquidity. By comparison, actual dealer to dealer trading represents 3 percent or less of total trading volume. There is something to be said for the system as it now exists and its efficiencies.

The cost of the current system of blind brokering should be gauged in context of execution and risk. According to these gauges, costs have been steadily shrinking. Brokers' commissions have been dropping, while volume and number of participants have

increased. As brokering commissions decrease to reflect the competition between brokers for transactions' business, this savings, in my experience, and I believe it continues on an ongoing basis, has been passed on to the investor.

The current system of blind brokering presents the dual risk of transactions' accuracy, one, all parties agreeing to a particular par amount and a price of a given transaction and two, when brokers act as agents, the consummation of the settlement of the transaction.

An extensive and thorough check-out procedure takes place regularly during any given day's trading to assure the accuracy of transactions. This procedure limits errors and safeguards all parties against possible mistakes. Thus, minimizing transaction capital risks. The diligent oversight by the Federal Reserve Bank of New York, Public Securities Association Committees, individual dealers and brokers, to maintain and monitor the capital exposure and creditworthiness of the "primary dealer community," to include those gaining entrance and those accepted, has assured that the settlement risks of a blind brokerage transaction is negligible. The primary dealers bear the capital risk to the settlement errors, as well they should. The Federal Reserve Bank of New York also shares in the psychological risk of any unforeseen event which may impair the functioning of this central marketplace, as well they should.

Assuming all qualifying standards are met by additional dealers in seeking primary dealer status, the transaction and settlement risks should not proportionately increase, as more qualified dealers are included into the blind brokering system.

The currently practiced qualifying criteria for transactions' access to blind brokering screens are a finely tuned combination of one, brokers' business and risk considerations; two, primary dealers' capital adequacy, and three, Federal Reserve Bank of New York participation in monitoring participants' reliability and performance.

Again, let me identify those participants who have provided the guidance and set the standards which have evolved and have been proven over time. The individual brokerage firms' business decision to service and to accept the transactions' risk of parties; the individual primary dealers' judgment of capital adequacy, management integrity and the capabilities and intent to share in all the responsibilities of primary dealership status, and the Federal Reserve Bank of New York's oversight and regular monitoring of market participation and thorough market making commitment by each firm.

These independent decisions, judgments and oversights are made on an ongoing and evolving basis by each type of participating institution, on the most currently reliable information and market developments.

The number of primary dealers and those seeking primary dealer status is not static. Those who are currently recognized or actively seeking recognition number approximately 50, double the number of ten years ago. Firms can be reduced in status from recognized to seeking recognition if any of the above groups independently seek that through reasons of capital management or market commitment. In other words, access once given can and has been later withdrawn in a few cases, due to the firms not maintaining a generally accepted level of any or all of the above criteria.

This balanced blend of criteria has evolved over time and has changed with the markets and new technologies. It will continue to change with the changing face of a global marketplace and changing regulatory environment, but the basic criteria should not be altered: Capital adequacy, business commitment, integrity, monitored participation, and responsibility as a primary dealer.

In my opinion, meeting only one or two criteria should not automatically give transactions access to the central brokers' screens, but not meeting only one criteria should deny that access.

An alternative system to granting transactions access to brokers' screens may well increase the chances of compromising the integrity of the central transactions marketplace without gaining a commensurate increase in transactions' efficiencies and cost savings. In bypassing present criteria for transactions access, the existing system may well change to reflect the added transaction and credit risks. Brokerage commissions may rise. Dealers may choose to do a counterparty transaction risk by restricting their execution within the broker system. As a result, market liquidity would suffer and execution inefficiencies would increase.

Primary dealers and non-primary dealers, regional broker dealers, investors and finally the Fed and the Treasury would suffer. A market system whose access was once coveted and sought now could be changed, possibly defaced and impaired.

To summarize, transactions access should be limited to those who choose to qualify on all levels of criteria, the risks of and to the broker-dealer and investor community are too great to dictate an untimely change in access to a system which is currently very efficient and has proved to be its own best guide toward responsible evolution.

Let me now address the question of information access to the interdealer brokers' screens. As opposed to the inefficiencies which potentially accompany wider transactions access to the interdealer screens, the wider informational access to these quotes should increase market efficiencies. Let me explain.

The wide dissemination of market information via rapidly evolving cost-effective communicative technologies can alert more participants to investment possibilities and provide more accurate quotation status to a greater number of Treasury and Agency issues. The same competitive quotation access currently available to all the non-primary dealer participants through retail screens are by and large limited to only the most active issues. This quotation information could be expanded to include the major bulk of Treasury and Agency issues outstanding, given the informational access to the interdealer screens.

Primary dealerships have evolved and developed large and wide-ranging arbitrage, swap and hedging capabilities, involving many if not all of the Treasury and Agency issues which they are called upon to make markets in for their customers and other dealers. Many of these issues rarely appear on the retail screens, due to their relative trading inactivity. Yet, they will normally appear on the interdealer brokers' screens because of the thorough and competitive market coverage provided by these specialized brokers. It is this brokers' sophistication and competitiveness to provide more "off the run" Treasury and "seasoned" Agency issue quotations which should be accessible to a greater number of participants other than just the primary dealers. In allowing wider informational access of this kind, the transaction potentialities are increased and greater market liquidity and efficiencies are extended to a larger number of Treasury and Agency issues, and more importantly, to a greater number of investors.

Customer contact with dealers is increased, the recognition of potential investment transactions is heightened and greater market and portfolio management efficiencies and liquidity should follow.

Another aspect of public informational access to the interdealer brokers' screens involves the more accurate pricing and valuation of new agency, corporate, mortgage-backed or derivative securities issues. The benefit of immediate, extensive and accurate market quotations could provide real cost savings to corporate treasurers, state and local borrowers and fiscal agents, not to mention myriad supra-national, foreign institutional and government entities, when they look to time and price their market participation and debt.

In summary, greater informational access hurts no one. To the contrary, it would serve best the vast majority of market

participants, i.e., investors. Greater investor/dealer communication should result along with more efficient and liquid markets in a greater number of issues. This should be a goal of this body's considerations.

This concludes my written comments to this Panel. Thank you.

MR. ANDERSON: Thank you, Mr. Kegler. We will start the questioning again with Mr. Simmons.

MR. SIMMONS: Mr. Stout, I am still trying to get a handle on just how much this market might grow with expanded access. I asked Lazard how many non-primary, non-aspiring dealers they thought might be interested in obtaining access. They indicated that while they couldn't quantify how many dealers might want access, that business in the market and the volume of transactions in the market would grow considerably.

Can you provide any evidence that would indicate how much the market would grow? If you think it will grow significantly, why isn't the broker picking up that business now?

MR. STOUT: I didn't hear the last part of the question.

MR. SIMMONS: If there is a potential for it to expand significantly, then why isn't the broker picking up that business now?

MR. STOUT: First in terms of how much it will grow, it seems to me that most banks execute for their portfolio with their own trading desk. Any bank with any portfolio at all,let's say, $1 billion in footings, is going to have fairly sizable portfolio trades to be done, especially when loan demand is down, throughout the economic cycle. It is hard for me to imagine any one of those institutions not wanting to know what the real price in the market is and what the volume traded at that price is. It seems incomprehensible that they wouldn't want to know that, given that that portfolio represents the net interest income for their institution, which is what the stock analysts judge them on.

So if I had to put a number on it, I don't think that I could do that at the moment in terms of number of institutions other than to say that with the economic incentives for an institution to know that it got the best price and the volume that traded at that price, it seems to me it would be all those institutions.

The second question, why aren't the brokers picking up that business. It has been our experience that they wouldn't object to doing that. We can't imagine any business not wanting more

customers rather than fewer. I am certain we do. I think, rather than asking the question why wouldn't they pick up that business, I think the question is what has prevented them from picking up that business. It appears to us that what has prevented them from picking up that business in the system which now exists is one which preserves its own access and there is great economic value in that access, and by limiting that access, that economic value remains.

MR. SIMMONS: Let me follow up just briefly. Wouldn't a lot of the problems that you alluded to in the response to the first question be solved by making real time sale information available to the public?

MR. STOUT: No, I don't think so. Our own institution executed billions of dollars worth of Treasuries last year alone, some billions for the portfolio, some billions within our own trading group. We don't have blind access to the broker screens. We don't have blind access to the market at all. When we execute a trade, the dealer or dealers who deal with us know exactly what we are up to, what we are going to do. If they have an opposite position to do, then we have found the most interested party in the market and we are happy. We have no way of verifying we have found the most interested party, but if we have, then we should be happy. If we haven't and anyone in the market, given the information as to what we are trying to do, cares to trade in front of us, it is going to cost us.

I make an allusion in our written comments to the fact that without blind brokering among primary dealers, speculators would be able to take the news of a large buy order, bid the market up, and raise transaction costs to the buyer. The reverse is true of a large sell order in the market. But in fact, the current system subjects us to that type of treatment. So I don't think price and volume information is enough, no.

MR. SIMMONS: Would it help just to see the screen, to have the screen?

MR. STOUT: It would help, but I still don't have blind brokering.

MR. ANDERSON: Mr. Thieke?

MR. THIEKE: Mr. Stout, in your opening comments you attempted to clarify what you thought were misperceptions about this concept of role of the market-maker, and I am not sure I followed your clarification as well as I would like and what significance you thought a firm having that designation should carry. You seemed to be implying that market-making really depended upon the ultimate investor. Do you see an economic role for dealers in this market as opposed to brokers, and, in a world

where there was expanded access to blind brokering, should it be limited at all to just dealers or to any participant in the market?

MR. STOUT: I will take the question of do dealers serve a role in the market first. I think absolutely they serve a role in the market. In a lot of institutions that are, say, fiduciaries or who manage a trust department or who manage a portfolio, they may have other duties to perform as well, meaning that they don't spend every minute of every day watching the screens trading in the market. Therefore, their familiarity with trends in the market, how sectors are trading, what type of volume there has been on either the buy or sell side is not as complete as the dealer's because it is the dealer's sole job to deal in that market. As a result, the dealer performs services for the final investor in many ways. I think that to say that opening up blind brokerage is the death knell of the dealers is false.

In terms of clarifying what I mean by making a market, it has been our experience that markets are made based upon what is on the interdealer screen. Perhaps an example would help. We call up a primary dealer and we ask him to make a market -- which we rarely do, by the way. We ask for bids and offerings. But let's assume that we ask him to make a market in the four-year note. The dealer doesn't because of his perfect knowledge of the four-year note quote me a price.

The dealer looks in the interdealer broker screens, sees that the four-year note is par 2-4 and quotes to us the par 2-4. Well, who is the 2-4 in the screen? It is either a primary dealer with a position that needs to buy securities at 2 or sell securities at 4, a secondary dealer who needs to do that acting through a primary dealer, or it is a final user of Treasury securities that needs to either buy them or sell them. It doesn't take place in a vacuum. So the idea of making a market, number one, hinges on the most interested party in the market, that is, that party that needs to do the trade.

Secondly, market convention has for a long time been markets are good for $1 million up when made to a customer. If you take that market convention and apply it to the number of dealers involved in the market, that would mean at any point in time the dealers are willing to bid any security for $43 million and offer any security for $43 million. Given the daily volume of securities has been $100 billion, it hardly seems like a high risk profile.

MR. THIEKE: If I could just follow up, do you see it appropriate to limit access to interdealer brokers to dealers? I mean a firm that holds itself out as a dealer in securities in a

market as opposed to a firm that may actively trade securities that are in that market, an investor or any other participant.

MR. STOUT: By dealer, if you mean someone who handles accounts who does --

MS. TAYLOR: However you choose to define it.

MR. STOUT: I see no reason to restrict it to just dealers. If there is a market participant who actively trades securities and has the credit wherewithal to be accepted on a blind basis by all other parties in the system, I can see no public interest to be served by excluding them from the system.

MR. ANDERSON: Mr. Kohn.

MR. KOHN: Thank you.

Mr. Kegler, the other witnesses this morning have argued forcefully that they thought that the public interest was harmed by excluding certain dealers from the screens and that their own private interest was harmed by this practice, that the price of securities, for example, in the public interest was higher or lower than it otherwise might be.

You seem to be arguing to the contrary, or at least your view is, in terms of access to the screen, to maintain the status quo. Would you care to address the issues raised by the other witnesses this morning?

MR. KEGLER: I think my feelings towards this should be taken in the context of a long-run business commitment. There are criteria that I have mentioned in my presentation that I feel are very important to adhere to on a long-term basis. It is not a simple market to understand or to have a prolonged commitment to unless you are constantly being evaluated on your own basis by those other participants in the market.

The public would not be served well by new participants who seek access to the screens during only the time that they want to be participants, if you follow what I am saying, during good times or during times when they have the internal capabilities of practicing this trade. The whole decision-making process would rest upon an individual firm's desire to pursue the business. Why not allow them to meet the criteria and standards that have evolved over a long time and, not unnecessarily, preserved the integrity of a giant market that the public participates in as efficiently as possible.

Maybe with different regulatory environments and changes you can increase efficiencies by increasing certain distribution aspects, but on a secondary basis, I think it is so important to

maintain the integrity of the market so that there is no question of risk transaction which could interfere with liquidity, which could definitely have a bearing on investors' costs in participating. I am not singling out any one firm.

MR. ANDERSON: Mr. Bremner?

MR. BREMNER: I think the point you are making, Mr. Stout, that I would like you to expand on a little bit more is that trading access be expanded to include all market participants -- dealers, traders, speculators, final portfolio investors -- so long as all other participants agree and are willing to deal with them on an undisclosed basis. A key point in that seems to be the agreement between all participants to deal with them on an undisclosed basis. I guess to a degree that seems like what exists at the present time, the agreement among the participants, and I wonder how in expanding the system to include all these other investors, you get to the point where there is that agreement between all these new participants.

MR. STOUT: I think the first step is to specify financial requirements for dealing in the system, and by financial requirements, I think it should go beyond capital adequacy. For all of our traders, we certainly have risk limits that we put in place. A trader has a stop loss, a trader has a position limit given our trust in him, the number of years he has been in business, how professional he is, et cetera.

I think those type of things happen at every shop. Every trader in every shop has a limit, has a stop loss. It seems to me combining financial criteria with basically stop loss and/or position limits until they warrant expanding is the right type of road to follow, and I think that can be done on a grander scale than 43 dealers.

What are the practical limits of that scale? I don't know. It seems to me that the futures market provides a pretty good guide as to how many people can participate in a market without having to worry about credit. Now there, of course, they don't have a blind brokering system as the government securities market has; however, they do have the Clearing Corp., which everybody looks to as basically being their credit risk. So they do have a way of addressing many more participants than 43, and it seems to have worked quite well given the growth of the Chicago Board of Trade.

MR. BREMNER: To the extent that there is this significant demand, why has there not been the further development, then, of some other way to accomplish this?

MR. STOUT: In other words, why haven't the primary brokers expanded to include other customers? I don't quite understand the question.

MR. BREMNER: For those who want to have the ability to trade on an undisclosed basis with other participants, there have not been any real pushes that I have seen to develop any vehicle designed to accommodate them. I have not seen much in the way of an expansion in this field beyond the utilization of the brokers currently which permit this.

MR. STOUT: I understand. First, I think there has been evidence of that type of thing happening. If you witness Cantor Fitzgerald and how it has evolved over the last five to six years, I think you will find that the amount of business it has done has expanded greatly. The amount of screens that Telerate has installed in shops has expanded greatly. So there has been an attempt there. However, I think it would be foolhardy to think that one could go out and start a new system that everybody could participate in without having the primary dealers involved.

Let's face it: they perform a very important role in the government bond securities market. Nobody is arguing that. To create a duplicate system that they could use if they wanted to or not use if they wanted to has already been done. That is Cantor Fitzgerald. They use it when they want to, but they have this nice little group over here that they can deal with on an exclusive basis that provides them more economic rent.

So I guess the two responses I have are that, one, that type of system has been tried, but without full support of the primary dealers, it is certainly not going to flourish as the primary brokers' system will; and secondly, we need the primary dealers involved in whatever system evolves out of this process. I think also the mere fact that the folks have shown up this morning to provide testimony here will prove the movement is under way, it seems.

MR. ANDERSON: Mr. Ketchum?

MR. KETCHUM: Mr. Kegler, if there is one thing that comes through fairly clearly from reading the brokers' brokers comments, it is that their primary concern is losing trading volume from the primary dealers, if there would be some concern as to creditworthiness in their system. Given that, wouldn't you expect those brokers' brokers, if there was no primary dealer requirement, to put in fairly strict capital requirements, fairly strict credit monitoring, perhaps fairly strict other related requirements as leverage and the like; and if you saw those combined with examination capability and periodic reporting that will be occurring at least as of July for all government securities dealers, why do you fear so much

for the liquidity and basic underlying soundness of the brokers' broker system if you lose the primary dealer piece of the attributes you listed?

MR. KEGLER: The primary dealers, in my experience, have provided the initial bid and offer market- making capability and liquidity. I have slightly different feelings about how markets are made than some of the other people who have testified this morning or given comment, and I believe you would be backtracking to a system of dealer-to-dealer trading as opposed to dealers primarily now using the interdealer trading system. You would be going back in time. You would be retracing a lot of inefficiencies that have occurred.

MR. KETCHUM: Why is that going to happen if the brokers' brokers replace the primary dealer requirement with a strict capital requirement in monitoring? Why will they leave?

MR. KEGLER: I think that as an individual firm or as a body, however they decide, maybe PSA subcommittee standards, they feel that they are their own best gauge of settlement risk. If an individual firm knows another participant and says yes, they are viable -- for our exposure, at least -- for up to x million dollars in transaction settlement risk, how are they to know, when there is an anonymity within the broker system, that that exposure is being increased or overextended by that participant with another dealer?

They would like to be able to monitor, I believe, not so much the risks involved, but the long term intent, capability and record of any participant which seeks to enter the brokers' interdealer system as an anonymous player. The inefficiencies will arise when dealer X who is a primary dealer, or recognized dealer under old criteria, says to the broker, you specify if there is a bid or an offering in there from this new participant, because it doesn't work with me. You have just eliminated a certain quantity of liquidity and execution, because I've already exceeded, or we have exceeded, our limit in transactions with this particular participant today.

I think the dealers or the brokers who are superimposing their own standard of criteria will not replace that which the individual dealers exercise on their own, nor nearly replace the monitoring function of the Fed in their activities in monitoring the managements of those firms choosing to qualify.

I would hope there would be lots of dealers, that choose to qualify under existing standards and criteria. The more the better. We are dealing with a Treasury security which in itself is a settlement. At maturity you will be paid, and so far, we have evolved a system of almost assuring riskless transactions

and settlement transaction risk within the primary dealer community.

MR. KETCHUM: And your feeling would be the same even with respect to identifiable discrete parts of the market, say mortgage-backed securities, where that dealer had been active continuously, perhaps did more than some primary dealers may do as far as an active every day market. You still feel that because he is not willing to commit to other parts of a market that seem somewhat unrelated, that there is greater risk include him in a brokers' broker system?

MR. KEGLER: Yes.

MR. ANDERSON: Mr. Simmons?

MR. SIMMONS: Mr. Stout, you indicate in your submission that there is no free market justification for requiring brokers' customers to have a business relationship with the Federal Reserve. Yet, these primary dealers and aspiring primary dealers are required to make markets across a broad spectrum of maturities in the market and be there when it isn't necessarily in their best interest. Don't you think that promotes market liquidity and efficiency in the secondary market?

MR. STOUT: I think there are two issues. I think one is the relationship with the Federal Reserve. I think the other is making markets. The relationship with the Federal Reserve is obviously necessary for the execution of monetary policy and we have no quarrel with that. We think that a relationship with the Federal Reserve to do that transaction, of either draining or adding to the system, is something that has to be done by somebody and there has to be some type of compensation for that. To suggest that the compensation is sole access to a blind brokering system oligopoly seems a bit too profitable to us.

The second question again, please?

MR. SIMMONS: You divided the question in two parts. My basic question was don't you think that having secondary market makers in the market that are willing to be in there when it isn't necessarily in their best interest, for example, when there is no customer demand or very little ultimate customer demand on one side of the transaction, don't you think that promotes liquidity and efficiency in the market?

MR. STOUT: To some degree. It has been our experience that if it is not in the dealer's best interest to make a market in a particular security, in a particular sector, at a particular market time, you will see bid offer spreads widen dramatically. You will see bids to miss. You will see offerings to miss. You will hear quoted again to you that market convention is one

million by one million. I am not suggesting that dealers don't provide a function and don't provide a service. I'm not suggesting that.

I am suggesting that they take the normal business route of trying to avoid undue risk, just like my firm would do, just like any firm would do. Yes, they are there to give the market participant information as to what is happening in that security, what has traded in that security, that the security isn't on the screens at the present time, that they will have to make a bid or offering based upon the last time they saw a spread to some other security, but to suggest that the dealer stands there in good times and bad and gets beat up because he has a patriotic adhesion to making markets in the Treasury securities, I think is absurd.

MR. KOHN: May I follow up on that? You do not share Mr. Kegler's concern that opening up the broker screens would at least under some circumstances possibly lead to less efficient, less liquid markets than we might see over broad stretches of time?

MR. STOUT: No. In fact, I take the exact opposite view. It seems to me that the primary dealer, as well as anybody else in the market, value and need blind brokering capabilities, for all the reasons we have mentioned. I don't think I need to go back through that again.

I think the main question here is not that, but I think the main question here is creditworthy counterparties. I think that is what this boils down to. Anybody dealing through a blind brokering system needs to be assured that who they deal with is going to deliver securities or accept securities and pay for them.

Right now, the system relies upon the participant being a Federal Reserve recognized dealer. Continental Bank was a Federal Reserve recognized dealer. Broker lines weren't pulled when they were having trouble. People are taken off the list for a time when the Fed suspects something is up. The dealers aren't told.

I'm not faulting the Fed for doing that. I'm sure they have reasons. It seems to me that we can construct some objective financial criteria that at a minimum will be acceptable to the dealers or other parties involved in that system. If they are a party to drafting those, they will even have a say in how those are drafted and what they look like.

I think we can design a system that gives the dealers more creditworthy information or more credit information than they now have. I see no harm in that. I see benefits in that.

MR. ANDERSON: Let me take the prerogative of the Chair here and keep the dialogue going and ask Mr. Kegler for a reaction to what he just heard.

MR. KEGLER: I don't think I agree with Michael. There is no patriotism involved in making markets. There is a bottom line business concern. There is also a responsibility that dealers have toward their position with their customers, toward the investors, and toward the Federal Reserve for providing bids and offers. Necessarily, a bid and offer can be specified for size. You can provide liquidity. In my experience, I have seen markets which would otherwise appear as being terribly illiquid, and they were Treasury securities that I had monitored with the Federal Reserve, the flower bond trading of early 1977. There were always bids. There was liquidity.

The non-primary dealers reacted in a fashion I would say would be typical of bad times. They would not take risks themselves, as they probably shouldn't. They would pass directly into the marketplace to the primary dealer. This is their function. Those bids were given with a dollars and cents categorization of value. You didn't make money tomorrow, you didn't make money next week, but you knew over time there was going to be a reaction. This is experience. This is management commitment to an ongoing participation. This isn't you make five cents today to make five cents tomorrow. You are in there for the long haul.

MR. ANDERSON: Thank you. Mr. Thieke?

MR. THIEKE: I would like to ask Mr. Stout, are there mechanisms that could construct a set of objective financial criteria to help deal with credit related issues associated with a market that trades blind through interdealer brokers? What might those mechanisms be other than regulation and supervision, and where is the boundary between the participants in the market setting standards and monitoring credit themselves as opposed to relying upon a governmental entity or governmental oversight to perform that function when they don't know their counterparty? Is there a proper place to draw that line?

MR. STOUT: Quite frankly, we haven't gotten into system design in our thoughts about the current system, as it relates to how to monitor credit. We have our own systems, as does every firm, to monitor the credit of the firms we do business with. We have certain exposures, both in terms of absolute size of trade and in terms of length of settlement that we impose upon our customer base.

I don't think I have the background nor the wherewithal to suggest at this time how we set that up.

MR. THIEKE: To what extent would the development of different techniques in the clearing process and possibly analogous to those that are used in futures markets make a material impact, in your opinion, on dealing with risk related considerations associated with trading through a brokers' market?

MR. STOUT: I guess I don't see a great deal of risk in the current clearing process. Most trades that take place are next day settlements. Our risk judgments are based upon, when we trade with a counterparty, normally, how much risk we will take over one day and what our assessment in the current market environment is for price movement during that one day period. You know next day whether or not a trade has settled and I think the market has been extremely efficient at working out those trade differences or fails on purchases or fails on sales very quickly.

I never really thought we were considering or thinking about how to more efficiently clear trades. I think we do it very well now.

MR. ANDERSON: Mr. Kohn?

MR. KOHN: Thank you. My question, I think, is related to Steve's, which is how would you bring about the new system? You said you thought that the current system was evolving but slowly. You had some very specific ideas about using clearing corporations, ala the futures markets, and you mentioned some other oversight regulatory supervisory agencies. How would you get from here to there?

MR. STOUT: I think what I meant to say was the evolving has stopped. The next step of evolution is to get some participation wholly from the primary dealers as well as those who use Cantor. I think we are in the process of the next part of evolution, and it either stops here or goes forward from here. That is what I meant to say.

MR. KOHN: Would it require something from the Government to get the process moving at a pace satisfactory to yourself?

MR. STOUT: I think so; yes. I think there are instances in this market and instances in the economy, for that matter, where some Government involvement is absolutely necessary. I think this is one of those things. We have to have an objective third party refereeing this match, it seems.

MR. SIMMONS: I guess I am a little bit perplexed about your view that the evolution has stopped. To the best of my recollection, in the middle of 1985 or toward the end of 1985, there were 36 or 37 primaries that had access; no aspiring primaries had access. Currently, there are 40 primary dealers

that have access and approximately 13 that have access to the interdealer screens, presumably some of those aspiring primaries that now have access were among the population of dealers that weren't in access to the screens and perhaps found that compliance with the primary dealer designation was the best way to accomplish that result.

Furthermore, I have read in statements that some of the dealers, some of the primary dealers, are showing their screens to their better customers, and that is something that is evolving, too. I guess my impression is there have been market developments that do indicate an evolution has occurred in the last year or so and the impression I have is it is still continuing.

Would you comment on that, please?

MR. STOUT: Yes. To say an evolutionary process in this market is adding more primary dealers doesn't sound very evolutionary to me. It sounds like the same old trade. It is the same old system. They follow these particular procedures and if all agree they will deal with that person, and the Fed agrees they have the correct wherewithal and they provide the proper reports, et cetera, then they become part of that system. That's not an evolutionary process. That is how the system works.

I don't see that as being an evolutionary process. The showing of screens to customers, some of the examples that were given were things like the Blumberg system which is provided by one of the primary dealers. We have that service. It is a super service for checking historical spreads, for checking spreads for possible arbitrage trades, for historical data, it is wonderful. For real time market information, it is useless.

I don't know who is supplying bid and offer screens to their best customers, but given the volume we do as a bank holding company, I'd sure like to know who they are.

MR. ANDERSON: Mr. Bremner?

MR. BREMNER: We currently have two types of brokers in the market: the ones that deal strictly with the aspiring and primary dealers and the ones that do not. In the area of those that only deal with the aspiring and the primary dealers, referring to the criteria, among the criteria is the commitment to make markets in the full range of Treasury securities.

I'm curious, if you were to categorize the degree of importance to expanding that to participants who do not make the commitment to make markets in the full range of securities, there are two expansions that could be made. One is to expand

it to other dealers that do not make the commitment and the other is to go on to all market participants in addition to dealers.

Could you give me your thinking on the importance of those two categories?

MR. STOUT: Yes. The way we view it is that again, markets are made by the most interested party, that party that has the economic trade to do. That sometimes is a primary dealer, that sometimes is a secondary dealer, that sometimes is a pension fund, a trust department or some other account, insurance company, or whatever.

It seems to me that if we have a system of blind brokering that allows any creditworthy party to participate, that what happens is the need for the primary dealer to "make markets in all securities," becomes even more hollow, because what happens is the participants who now have direct access to the screens are going to put those bids and offerings in there themselves. Why do we need to go through another channel to do that.

It seems that would mean the risk to dealers, primary dealers, actually would be less in a system that expanded to include more market participants, because the numbers on the screen if they have to make a market would be more reliably there and there more often, given more access to people who trade those securities.

Again, we fall back to what is market-making. Market-making is making a bid or offer based upon what is on a screen or last on the screen, and what was last on the screen or what is on a screen was either a dealer, secondary dealer or final user who had a trade to do. Increasingly, I think you find the business moving away from customers calling a dealer and asking them to make a market. I think the dealers have done a very good job in training the customer that asking for a bid or an offering lowers their risk profile and as a result, they get better information and better service, et cetera.

I think the risk profile of the dealer has been lessened by that education. I think that is a positive step. I think the next step is to give direct access to those who have a better offer and let them put it on the screen themselves.

MR. BREMNER: It sounds as though your definition of making a market is only giving both a bid and an offering at the same time, as opposed to responding to a request of where would you offer or bid, if that were the question. Also, continuously making a market sounds to be, if I understand you correctly, the same as an investor's occasional purchase or sale of a security. I didn't think that was what you meant, but that is the way it sounded.

MR. STOUT: Let me see if I can clarify that. My colleague has mentioned those dealers have always been willing to stand by and make a bid even in the worst of times on securities that are on the screen.

MR. KEGLER: I didn't make that distinction.

MR. STOUT: That is what I understood it to be.

MR. KEGLER: All securities.

MR. STOUT: Let's make it all securities. At a certain price on either the bid or offering side, the security has relative value to another security and our own arbitrager, of which we have a couple, would be glad to purchase that security, short another security and ride that spread for any amount of time it was necessary to do so. There are ways to make bids and offerings in the market at the correct price that those with market experience would be willing to do.

I want to move away from the thought that the reason these bids and offerings are made is solely because one feels duty bound to support the U.S. Treasury during hard times. Certainly, that feeling of allegiance is there. I won't deny that. Certainly, that loyalty is there. I won't deny that. I've had the same myself.

When it comes down to the bare facts of why a particular bid or particular offering is given during good or bad times in the market, it is either because the dealer knows a customer has an opposite trade to do, the screen shows him a party of any type that has the opposite trade to do, or there is an arbitrage position that can be taken or the risk be laid off in the futures market or any number of ways. Yes, it provides liquidity. Yes, it supports the market. Yes, it makes the market more efficient. There are reasons why it does that that are apart from pure allegiance to a market. There are ways to lay the risk off.

MR. ANDERSON: I have to give Mr. Ketchum a chance to get in on this round.

MR. KETCHUM: Mr. Stout, if First Banks System had access to the brokers' brokers screens and access to the system, would that change in anyway the manner in which you deal in Government securities?

For instance, would you increase your capital commitment, do you think? Would you increase the size of positions you might be willing to take? Would there be any direct impact on the size or method of your operation by that change?

MR. STOUT: Yes, there would. We would be willing to supply more capital to our business. We would be willing to take our volumes up further than they are and more aggressively seek business.

We would also still use the primary dealers from time to time. They have expertise we don't have. And we feel a benefit in using them because the expertise that they have we need on an occasional basis, not a full-time basis. I would rather rent that expertise than purchase it. I can rent it from a primary dealer. I can pay him for his service.

I can also verify price. I can also verify volume and it becomes exceedingly important with the kind of customers we deal with because they rely on us to give them that information or provide it to them.

Our own system purchases a large number of Treasuries. We would like to make sure that we are getting good execution. We trust the people we deal with. We have good relationships with people we deal with. But I would certainly like a screen telling me that I got the best price I could.

MR. ANDERSON: Gentlemen, thank you very much. You're excellent witnesses. Thank you. We appreciate it.

Next we have a group of people that we've labeled investor associations. Mr. Bruce Brummitt, are you here, sir?

MR. BRUMMITT: Yes.

MR. ANDERSON: Mr. Brummitt is the Executive Director, New York State Association of School Business Officials for the Association of School Business Officials of the United States and Canada.

Mr. Rodger Shay, are you here, sir?

MR. SHAY: Yes.

MR. ANDERSON: Yes, thank you. Mr. Shay is the Executive Vice President, United States League of Savings Institutions.

We have another witness not shown on the agenda. Mr. Richard Hamecs, Senior Director of the Mortgage Bankers Association. Mr. Hamecs? Is Mr. Hamecs here?

MR. ANDERSON: I guess our addition didn't make it. Mr. Brummitt, we'll start with you, sir.

STATEMENT OF BRUCE BRUMMITT, EXECUTIVE DIRECTOR,
NEW YORK STATE ASSOCIATION OF SCHOOL BUSINESS
OFFICIALS FOR THE ASSOCIATION OF SCHOOL
BUSINESS OFFICIALS OF THE UNITED STATES AND CANADA

I appreciate the opportunity to be here. I think I am on the wrong side of the table because I'm a governmental person and the questions that you are asking are the ones I came here to be educated on.

However, I did comment specifically on the questions. Rather than go through that, I'd like to briefly tell you it in a different way.

I think I represent, I hope I represent, all the municipalities in the country. Certainly, I can speak for the school districts. And, I am one of those battered people from New York state through LION, RTD and EMS, BBS and the rest.

In New York, our short-term market is $3 billion. Just the school market. I don't think a lot of people realize that there are 27,000 municipalities that are borrowing, investing, need collateral and so on.

When you add collateralization to it because we are a 100 percent state on collateralization, you are talking about a lot of money. When you look at who buys and who owns federal securities, we're big owners, meaning all the municipalities.

But at the same time, we have the same taxpayers, the same Congressmen. When I go to the hearing and hear the SEC Director testify, I think he is testifying to me when he talks about fraud in the marketplace because it is not hard for me to call Barnett or somebody else and talk with them because we are in Government together.

I guess what I'm really concerned about in this whole issue is the public interest--protecting public funds and the cash management aspects of Government.

We have a position which is very simple. And it says this: "Public access to all final sales information should be public." It is a public sale. I don't know how you can keep it from being public if we really challenge it.

There are sunshine laws in the state, in this country and in our state. Also, you don't want insider problems. Primary dealers come pretty close to having inside information, to us.

I'm not talking about across the counter sales, no part of that. I'm talking about final sales. We ought to

know who sold what to whom and when. I can't even find out whether I own something that somebody sold to me and whether they are accountable if they told me that I had an interest and gave me a piece of paper saying that I have.

Now, I know what's happened in SEC in being able to pursue some of this. But I also know how many cases Bradford Trust had against them or how many complaints were investigated. I have a list for BBS. If I had had those when I was talking with school districts about investing, they would have never touched those firms.

Also, I have known through personal experience two of the primary dealers who were in trouble. And, one not too far distant from this time.

We can't understand how this would add any cost to the Federal Government of selling securities. This kind of information is worth money. We pay for it.

How could it possibly add in the process. You know it might reduce the need for regulations. If it did that, it would reduce the cost of marketing.

I think you have to look at these issues. And, it would also reduce the opportunity for fraud. That should be evident.

There are some concerns and I thank Paul for involving me in reading a lot of papers since October 1984 and GAO for doing a nice job on teaching me what I should have known that I never knew.

However, out of all of that some things have occurred with us. First of all, we believe that the public investor really has a poor opinion of the value of buying in a secondary dealer market, maybe in the primary. It is not a lack of confidence in you or the Federal Government but I can't take the risk with public monies of going through a dealer arrangement until you make those people accountable when they lie.

We'll take risk. We understand that. So, what's happened is that you had a withdrawal of public investors from the market. And I can give you examples of why and the very kinds of things that they have told us -- my own state comptroller has said stay out of that market.

Now they've scared me to the point where I use a public advisor -- a fiscal advisor for my public financing. And, where I'm told in the press, that the comptroller of my state says that I don't really know as a business official much about this whole market and therefore I should not even be

trading in securities, that only the state should. Well, I know that the state uses commercial paper. I have a real problem sitting out here as a person who is supposed to understand what's going on.

We are feeling something that we don't understand. There is a fear among you that you are not going to be able to fund the public debt. And you are saying to us, "Don't touch that structure because it works very well, and it's a safe thing, and we've got to increase it 400 percent." Boy, this is the wrong time.

If you want to market federal securities, let me respond to how I would go about it. On one hand, you've got the Tax Reform Act that actually is working against the sale of federal securities to us. They are less attractive. We can't do what we did before, arbitrage and all the rest.

And, look, we are not on the other side. I support, financially, any program or any Congressman that will try to reduce the public debt. With respect to competition for investors dollars, you are telling me that I'm in competition with you for local investor dollars. Now that's a mistake because I'm closest to those taxpayers. I got this perception from reading the first study in October '84. I didn't understand these kind of things before. I read the Tax Reform Act word-by-word all the way through.

You know I read things in there that said to me we're going to make it harder for the local community to market its paper. There is only one reason I can figure out for that and that's so you can market more, you can sell more. We're working with the same dollars. If you don't think that's true, think about this. If a state wanted to say that it would change its collateralization requirements and take commercial paper, and there are some of them that do, or if it said we will only take municipality and state paper for collateral in our state, you see how we get to playing a game between each other. You've changed all the rules on us.

We meet with the bond counsels. We meet with the investment bankers. Some of the people here are business associates in my organization. You know, we're a little concerned about what's going on in all of this. Maybe we don't understand. But as a student of American history, there is a constitutional issue.

We agreed a long time ago that we wouldn't tax each other on our securities. It was an unwritten rule. And now we play these games: whether it IRS 85-15 or 55, I've forgotten which one it was, where we played with this. And we are skirting there and

that scares us in the process because we're now talking to people who want to bring it up as a constitutional issue.

Now, I've said a lot of things. I don't want to be misunderstood and I really think that we can do a lot of things to improve the market. SEC doesn't encourage, as near as I can tell, the pooling thing. We now have pools for borrowing investment at state level, can deal directly in great amounts and buy your Fed paper and we don't need dealers in the process. Now, that scares some other people but there is a structure that would give you a way of selling an awful lot.

If you need more people who can market, it's not hard. It's usually a state comptroller that acts with a temporary investment fund.

Well, I'm glad to be here. I hope I'm not an enemy to the dealers.

MR. ANDERSON: Thank you very much, Mr. Brummitt.

[See appendix IV for the written statement of Mr. Brummitt.]

MR. ANDERSON: Before we continue, you may notice there has been a change in the panel up here. Mr. Ketchum had to go to a meeting with Commissioner Shad. We now have Brandon Becker, Associate Director, Office of Self-Regulatory Oversight, Division of Market Regulation. We will now hear from Mr. Shay.

Welcome, Mr. Shay.

STATEMENT OF RODGER SHAY, EXECUTIVE VICE PRESIDENT,
U.S. LEAGUE OF SAVINGS INSTITUTIONS,
INVESTMENT SERVICES, INC.

MR. SHAY: Thank you, Mr. Chairman. I'm here this morning in two capacities. First, representing the United States League of Savings Institutions which in its 3,500 odd members represents over 95 percent of the assets of the thrift industry. Secondly, as Executive Vice President of a wholly owned subsidiary of the U.S. League called U.S. League Investment Services. This is a registered broker/dealer that provides products and services in the liquidity investment area for members of the U.S. League.

I thank you for the opportunity of expressing our views on the subjects before this panel. I would like to address two questions specifically.

Should the investing public at large have access to the price information now made available only to the limited number

of dealers? Should the same investing public be granted direct access to the market served by the so-called screen brokers?

My answer to the former is a definite "yes." To the latter, a qualified "yes." The communication of information to the ultimate investor probably did more to broaden and deepen the Government securities market over time than anything else.

Telegraphy was once used to move price quotations from trading rooms to remote sales offices. From these points telephones were used to disseminate bids and offerings. Finally, CRT devices were installed directly at the desks of investment decisionmakers. These devices carried news, financial information, and have become the primary source of the retail broker screen.

Despite the imperfections of the retail broker screen, it has done much to improve the market through the pricing system. No longer does the investor rely solely upon the integrity of a dealer's price before executing a transaction. The investor can now see before him actual purchases and sales and then relate the execution that he is contemplating to real live market prices.

As each new level of sophistication has been reached, the efficiency of the market has been improved through greater participation which allows for larger size transactions and narrower spreads between bids and offerings. The importance of disseminating live price information, in my judgment, cannot be overstated in the context of market integrity.

Let me share with you the attitude of some market professionals relative to this pricing information. U.S. League Investment Services is staffed by 30 account representatives whose responsibility it is to serve the liquidity investment needs of those of the 3,500 members of the U.S. League who choose to use our services and products. When the question was asked of these account managers as to what information delivery system should be chosen for each of the offices in which they were serving, the only criteria set by all 30 was that they have the ability to access the retail broker pages.

If access to this information is so desperately important to market participants at these levels of sophistication, and the retail screen by its nature is inferior to the primary broker screen, how much more important then is the accessibility of the primary screens themselves? In my opinion, it is absolutely necessary to open this informational source to the entire market for greater effectiveness.

The second issue is more difficult to deal with. The financing of the public debt cannot be compromised in the slightest. The primary dealers will claim that the exclusivity

that they enjoy in the area of recognition, special business-like relationship with the Federal Reserve and sole access to the primary brokers, is more than deserved due to the role that they play in the underwriting, distribution and market-making for the U.S. Treasury securities.

Before the creation of the primary brokerage market as we know it today, a relationship of sorts existed between the Fed, the Treasury and the Government securities dealers. So one cannot say with certainty that this relationship will be jeopardized by including non-primary dealers in the circle of users of primary brokers.

Primary dealers buy and sell, primary dealers position securities, and primary dealers make markets. So do a lot of non-primary dealers. Primary dealers also back away from certain markets at certain times, and so do non-primary dealers. There are also a large number of non-dealers who could argue that their role in the market is so close to that of a dealer that access to the primary brokers would lend greater depth to that market.

Obviously, they are players in this market already, and if the primary brokers market is closer to the perfection of that marketplace, why not remove an intermediate step and bring in this additional capital directly? I believe that protecting the exclusivity of primary dealers in the primary brokers market inhibits superior functioning of the government marketplace.

Another argument to be raised concerns credit. To my knowledge, there has never been a nonperformance problem. When disagreements arise, they are settled between the dealers and the broker involved. When you consider how many billions of dollars of transactions in this market are supported by such small capital accounts, you must be amazed by the real efficiency of that marketplace, but in and out transactions, next day settlements and relatively minor price swings should not require prohibitively large capital accounts when the liquidity and the security credit is so favorable.

Also, the nature of the primary brokers market is such that transactions are executed on the basis of price and size, not on creditworthiness. The largest, most vulnerable positions at the close of a day's trading can fall solely upon the least capitalized primary dealer. Creditworthiness or capital sufficiency is not the argument it is made out to be. The vast majority, if not all, of the failures in the government securities market from the perspective of the dealer have been attributed to fraud, not financial destitution.

While I cannot come down squarely in defense of the status quo, I do have some feeling of support for the positions of the

primary dealers on this question. Intellectually my experience urges me to view a completely open primary broker market as the most efficient possible. My suggestion to this august group for resolving the question would be the following.

For market participants of all persuasions or degree of involvement, allow complete access to the pricing information on a timely basis, available through all brokerage entities. For a limited number of qualified non-primary dealers and non-dealer investors, allow access to trading through primary brokers on an experimental basis. Should this prove successful, it could lead to an expanded universe of participants until finally that greater level of market efficiency is achieved.

Thank you.

MR. ANDERSON: Thank you very much, Mr. Shay. Before we proceed to the questions, did Mr. Hamecs arrive since we started here? Apparently not. Mr. Simmons?

MR. SIMMONS: A question for either of you. Following the failures of ESM and Bevill Bresler and others, there was much talk about a flight to quality dealers. What I would like to try to get on the record is your impressions of how significant that flight was and, if it was significant, what the basis for making the distinction between quality and non-quality dealers was?

MR. SHAY: From my point of view, Mr. Simmons, there was unquestionably a flight to quality. I have a personal experience in that. The company that I was a principal of had just sold its firm to the U.S. League for Savings Institutions, and during that period when ESM and Bevill Bresler were making the headlines on a daily basis was the period in which over the last two-odd years that we had the greatest number of members of the U.S. League come to us to seek out our services. So I can tell you first-hand that there was a substantial flight to quality.

Secondly, I would say that it was the perception of those people in the marketplace for the most part who sought out the primary dealers, principally, rather than any other participant because there were many of the members of our own U.S. League, even though we are wholly owned by the membership, who did not feel that we were worthy of being the counterparty in the transactions in which they wanted to engage. But there seemed to be an aura around the primary dealer fraternity that drove many, if not all, of those that changed to the primary dealer community.

In my judgment, it was done as a result of the seal of approval, so to speak, that was perceived to hang over the doors of the primary dealers, and secondly, as a negative, it appeared to me that it reduced the liquidity of the market tremendously at

that point in time because the entire market could very well have become captive to the limited number of dealers, those primary dealers.

MR. ANDERSON: Mr. Brummitt, do you want to supplement that?

MR. BRUMMITT: Three things. One, we had meetings of 500 people at a time across the state talking about primary dealers, and one of the most vocal spokesmen--not invited, but who forced his way in consistently--was a person from BBS, supposedly a quality dealer. While we are going through this, he called me up one day and he said: I want to tell you that we are in bankruptcy and I didn't know it, and what I told you was honest and I'm embarrassed to be involved in this. I respect him for that. But you want to talk about quality dealers? I really don't know.

Now, the market dried up for another reason. I had people brought up on charges, business officials whose careers were ended, superintendents whose careers were ended because they made bad investments. Even the comptroller would say this. They made them in repurchase agreements. The comptroller said we shouldn't be--you can find this in the headlines. He said we should not be dealing in repurchase agreements. Now they have wiped out that market. No question. It didn't make any difference who was dealing.

Another thing occurred. We were told that really this whole issue was because we didn't have the ownership of the securities that were pledged as collateral; therefore, we were to go out and request that from banks, from anyone. So that if I had money in your bank, you now had to give me an ownership certificate and it had to be held in another bank. It couldn't be in your bank, not in your trust department. Banks have refused to do that almost without exception in New York, even at a price. They will do it within their trust departments.

Now, that is a Catch-22. So what you do in the process is you keep your money right in your bank. What do the banks do? I don't blame them. It is good business. They turn around and give you Super Now accounts, and they say to you, really, you don't need to be in the CD market because you just stay with us with the savings thing and we will give you a daily rate in your balance and give you pretty close to the best rate you can get out there.

I don't think the market is there anymore. The net result has been that where we used to be arbitraging and that gives you more sale of securities, it is almost gone. Then we had Alan Procter, Federal Reserve, who wrote a paper not too long ago, and I think it was Summer Quarterly, saying that we shouldn't borrow any money unless we really needed it, and only by the day. He made a very good argument for it. That's fine, but that isn't

going to sell your securities. If you really want to market, that dries up part of the market.

So these kinds of things and the statements that have been issued nationally as model guidelines for local municipalities say don't deal with secondary dealers, be careful even in the markets you are in because there is no way to regulate. The quotes are here. I will be glad to share them with you.

If you are out in the public field, you are not going to sacrifice your whole career over an issue that we are not very clear on what it is all about. For years I trusted bankers, I trusted Treasury agents, I trusted the Federal Reserve system until I find out even my friends in the Federal Reserve won't tell me who aspiring primary dealers are, and I say how can you do that? How can you refuse to tell me? What if I get a court order? "Well, that's our position." I am confused at times. Maybe I know either too much or too little.

MR. ANDERSON: Thank you. Mr. Thieke?

MR. THIEKE: You can't possibly know enough. I would be interested in the comments of the two witnesses on the extent to which they would think in time that the introduction of a limited framework of regulation and supervision in the government securities markets was likely to work to change investor attitudes and, to an extent, increase investor confidence in the full range of participants in those markets.

MR. SHAY: I have to say--perhaps somewhat reluctantly because I took a contrary position for so long a time as a member of the industry, as Chairman of the Board of Merrill Lynch Government Securities, among other things--I have to confess, despite all of my past positions on the subject, that I think it will enhance the perceived integrity of the marketplace and give greater comfort to the investing public.

MR. ANDERSON: Mr. Brummitt?

MR. BRUMMITT: I am less concerned than I used to be about regulation and more concerned about the pursuit of fraud. Really I believe the system works very well. The only problem is if I abuse it, nothing happens to me, or it didn't used to. I would get a letter and I would say I would comply. I didn't, and you would send me another letter. There were 205 of these against Bradford, for example, in a period of time.

Really, if you can tighten up--and I sympathize with your chairman. He did a good job May 15th when we went through this. Nobody is going to go out there and do something when the risk is whether they are in business anymore. Bankruptcy is no answer. You can go back in business or go under another name.

Reporting and auditing and pursuit of fraud. Maybe we better take another look at regulation. Every time we get into it, we somehow inhibit the market, we increase the costs, and we make us all angry at each other. The reporting system is fine. The auditing system is fine. It is just when we find the troubles that we aren't able to take care of those very few, and they are few, of those dealers who are involved in fraud.

MR. ANDERSON: Mr. Thieke, follow-up?

MR. THIEKE: No, thank you.

MR. ANDERSON: Mr. Kohn?

MR. KOHN: I have questions for each witness on the kind of information that they want. Mr. Brummitt, you said you wanted public access to all final sales information, but it wasn't clear to me exactly what you meant by that, what sorts of information you were asking for. Mr. Shay, you said you wanted access to the screens, to the primary dealer screens for information purposes.

Some of the submissions from the primary dealers and the brokers have talked about not wanting to reveal the bid/asked, the actual market bid and asked quotations. I wonder whether you would be satisfied or you think the same purposes would be served if you got final transactions information rather than the actual market spreads, whether that would serve your purposes?

MR. SHAY: From the point of view as a nonpositioning dealer, which we are at U.S. League Investment Services, I would say that would not be satisfactory at all. Then from the point of view of a major participant in the market, as some of the members of the U.S. League are, who I would include in that non-dealer group, by the way, that should have access to the trading function, I would say it would also not be in any way satisfactory. It would serve no purpose.

You have only to look at the success of the Cantor Fitzgerald screen on Telerate to see the format, to see the revelation of information, to, I think, get insight as to what the market is looking for coming from the primary brokers. It boils down to bid, asked, execution and volume.

MR. ANDERSON: Mr. Brummitt?

MR. BRUMMITT: There are two questions in my mind. One is the final sales gives me what I need but I can't speak about the market. I understand what he is saying. Maybe I would agree with him if I had some stock in his company. I probably would. I don't really feel I should comment on that. That is how you make

it work. But I know that I should understand what happened out there afterwards. I'm not sure whether I as a public official should have any interest in what the offer and the quote and all that was. I do have some of that from the people that I work with, but it doesn't help me that much.

MR. SHAY: I would think as an ultimate investor, however, you would want to see it.

MR. BRUMMITT: I will think about that. I'm not sure. You may be right.

MR. ANDERSON: Mr. Kohn?

MR. KOHN: For Mr. Brummitt now, seeing the final transactions data, this is the information you were seeking, or is there additional information you would like to have about the transactions?

MR. BRUMMITT: Well, I need with that also the audit report, the monitoring, all of this. It is a part of the same thing. I wasn't concerned about banks failing because they have money in there until I saw the Trouble Watch, and when I realized that the system was going to allow banks to fail, I got myself adjusted to that, so now I have to hire somebody who advises me on which banks may be in difficulty, and now I understand two different ways of how banks are balanced.

That also gives me concerns when I look at the credibility. This is all part of the same thing. This helps me measure what that dealer really is. That dealer is representing the Federal Government. That is what bothers me. A car dealer wouldn't be in business if he had that kind of freedom. The company would take it away, and I can't understand why you aren't able to take it away from him if he besmirches the market.

MR. ANDERSON: Mr. Bremner?

MR. BREMNER: Did I interpret that to mean that the comments you made earlier about who sold what to whom, that you don't feel a need for that information, that you just want to be sure that somewhere in the process there is some form of an examination where the records are being looked at? Is that what you meant by that?

MR. BRUMMITT: Let me read something to you by a person who gave me a piece of paper and said that is a certificate of ownership of a security, a Federal security. This is Thomas J. Perna, under oath, testimony June 5, 1984. "If I wanted to do a repo and use as collateral camels in Saudi Arabia, and I have got a school district that wanted to take that collateral, it is their business to know what they can invest in, not mine.

Now, I have been called unknowing, ignorant, naive and a lot of other ways because I trusted people. I will never trust somebody like this again, so I want all the information so I can see it myself. I am not even sure I will trust an adviser any more. I will read the audit report -- I'm getting better at that -- even though that could be falsified.

MR. BREMNER: So what you really mean is when you are the purchaser of a security, you are looking for some documentation that you actually did purchase it and who you purchased it from? Is that what you mean?

MR. BRUMMITT: I think it is still occurring that you will find banks who give up 200 percent of the same collateralization until they get caught. It is too loose in the system. People say, oh, I made a mistake on the number. I was really talking about another certificate of another date. You would be amazed. The more information I can get, and if I can get an audit trail all the way through or I can get your information when I know somebody is under investigation, I will be a lot better person to protect the public interest.

I felt inadequate in the past because I didn't know enough, and now I feel inadequate because I called up the person in the state, who I won't name, who is our chief adviser for investments and securities, and he was a banker for 18 years at Merchants and Traders, and I said to him: Jim, what is blind brokering and what is this screen business between the dealers? He said: I never heard of it.

No dealer ever told me, and I'm working with bond counsels and other people. I really feel at a loss, so I need any kind of information I can get and all of it. Maybe someday I will say hold, enough, I have got it all, but I am accused of not knowing enough about this as a local business official.

MR. BREMNER: This is a question for Mr. Shay. I guess I should ask this in the form of a question. Is your organization an investment advisory service or are you a broker or dealer? You used the term "counterparty," that some of your members of your association were concerned about using you as a counterparty. I wouldn't view an investment advisory service as a counterparty. I'm not sure what your function is.

MR. SHAY: It's not called U.S. League Investment Advisory Services. It is called U.S. League Investment Services. The fact of the matter is that we do act in an advisory capacity to the members, however, at the same time we also are a non-positioning dealer, in that we act as principal between our members and the dealer community for the purchase and sale of securities.

MR. BREMNER: You actually are not an investor but a middleman in the process, as a broker?

MR. SHAY: In the context of this discussion, yes. We do happen to have a mutual fund that is $2 to $3 billion in size that is an investor for its own account. In the context of this discussion, I am talking about our dealer activity, which goes hand in hand with our advisory services.

MR. ANDERSON: Mr. Becker?

MR. BECKER: I would like to follow up on Mr. Kohn's questions. With respect to the specific data that would be made available or you think should be made available, quotations, the rationale that some commentators offered for not making quotations available was that would mislead potential investors due to the wholesale nature of the market.

I would like both of you to comment, if you would, on that argument. I gather I hear Mr. Brummitt saying he might not feel a need to use the information but if he did want to use it, he would get up to speed to understand the information. I would appreciate Mr. Shay's views also on the ability to interpret that information.

MR. BRUMMITT: All I bring here is a lot of years of experience. I can only read so much and contain so much and I can be double talked very easily by a primary dealer until I go out and check the process. What I am using frankly is a control device. If I can get to some data, I can cross check. That is one of my management functions.

In knowing what the quotations, the offerings, and all the rest, and I buy stock myself, it is not that simple. I don't want to be confused by information that may lead me down another track. I really have to think about that. I tend to use somebody else to advise me. It is worse than being your own lawyer. I just came here to testify because I wanted to expose myself as a business official to you, to show you where I sit and think, and how some of this stuff occurs and we get taken in. This is maybe one percent of all I do, and then I'll get paid extra for it and I have no staff for it. I have to depend on other people. I have to do a lot of reading, a lot of questioning and be very suspicious. I like what you do. I can read what you have, SEC.

MR. SHAY: My view of the position that has been taken concerning the dissemination of the information is that it is rather self serving. I don't in any way envision the confusion that is referred to being very widespread in the marketplace, particularly in light of the fact that my vision of how this

information would be disseminated would be on a sales basis through some kind of information delivery system.

MR. BRUMMITT: That is different. That I could use and use very well, if somebody would do the filtering or the interpretation.

MR. SHAY: And to the extent that represents the wholesale market, who is to say where the wholesale market ends and the retail market begins. In my judgment, anyone who has the capability of performance in the market and the size in which the market demands should be considered as much a part of that market whether it is the wholesale market or not as any other participant. Everyone should be on equal footing. There should not be any privileged few.

MR. BRUMMITT: Insiders.

MR. SHAY: It is the same argument that could be used today with the accessibility of the Cantor pages on Telerate. Those of the investing public who choose to purchase the rights to that information are free to do so.

MR. BECKER: I guess I hear you saying there is going to be either one, a self selection and the people who pay for the information presumably will be capable of using the information they have purchased, or you will see the creation of intermediaries who will be in the position to use the information, to explain it to Mr. Brummitt, hopefully without any fraud involved.

MR. SHAY: Certainly so. You would be amazed at how quickly they will get up to speed.

MR. BRUMMITT: There are people that do bank watches, you know, and I can buy what I need for a lot cheaper.

MR. ANDERSON: We have a little bit of time left. First, I will ask any of the panelists, rather than trying to go around again, whether they have any additional questions. Mr. Becker?

MR. BECKER: Mr. Shay had referred to a limited access program of trading through primary brokers. You seem to be trying to suggest a pilot or some sort of way of walking people in without creating a big bang effect. Could you elaborate on that?

MR. SHAY: Again, my vision of an expanded system would allow for perhaps modification of the voluntary guidelines for capital adequacy of the Fed, to be used to broaden the list of dealers accessible to the primary brokers. You might even establish a category of non-primary dealers and make it a very specific category as far as the qualifications are concerned.

I would then take it a step further and examine the major players in the market, and for those who would choose to have that accessibility to the trading system or the primary brokers, to yet establish a third category, to enable them, depending of course upon creditworthiness and other factors. The criteria could be set, as someone earlier this morning indicated. That would not be difficult to do. Now that we have Government regulation in, we might as well use it effectively. In my judgment, that experimental program can provide for all three of the categories that I just mentioned to operate side by side in that market and to not only allow for the status quo as far as the efficiencies of the market is concerned, but to enhance it tremendously, by giving it the greater depth and breath.

MR. KOHN: Mr. Shay, it strikes me that you are one of probably the few witnesses we will see today that have been sort of on both sides of this, in terms of being a primary dealer and now outside a primary dealer. I was going to ask you for your perspective from that. I would presume that a number of years ago you would have been sitting up there defending the status quo, now you seem to believe that there is a better way to do it, that price spreads might be narrower, the market more efficient, more liquid, if there were greater access, that your customers would get better prices for their securities.

Is that a fair summary?

MR. SHAY: It certainly is. That is very wise of you. I spent 25 years on the other side of that argument. I must confess to you that beginning in 1981, when I set up my own firm as an independent advisor, I did find it somewhat difficult to rationalize my former position with my new found one. However, recognizing who signed the paycheck at that point in time, I found a way to rationalize it.

That is the easy answer. The real answer and the honest answer is that it can't be denied to me, I mean it can't be argued differently, that when you sit as an independent viewer of the market, having the capability of accessing all of the players in the market, and having no position to govern your making special bids or special offerings, that you are far more objective and can effect a far more lucrative bottom line to the investor, that's the way I like to put it. When it comes to the membership of the U.S. League, for example, there are very few people now that don't recognize the fact that they were leaving a lot on the table when they were doing business in the old fashioned way.

The more you close that gap, the more information you make available, you are simply providing again the more efficient

market and the way toward savings on the part of the investing public. I have to be honest in saying that.

MR. ANDERSON: Mr. Brummitt, you can have the last words.

MR. BRUMMITT: I think the problems that we are in had to do with interest rates, 17 percent. We had an abnormal situation when I could make as much as 9 percent on a spread. I could see how people could go out of business over a weekend because the market changed so fast. It wasn't really their fault in the process, but we didn't have any way of finding out what was going on. If I was on the edge of bankruptcy, my only survival was selling, I sure wasn't going to tell anybody I was in trouble. Now is the time while it is not destroying anybody to set some of these things up, hopefully, inflation and interest rates will stay down. Our great failures and problems came out of a very abnormal market.

MR. ANDERSON: Thank you. Mr. Shay, we thank you very much. Mr. Brummitt, it has been a real pleasure.

I see some of our other witnesses are still in the audience. I would like to again thank them and remind them of the statement I had made earlier, that we appreciate the fact that they would be responsive to some possible questions, either in writing or perhaps over the phone, where we might want to tap some more of their expertise.

On that note, we will now break until 2:15 and reconvene then. Thank you.

AFTERNOON SESSION

MR. ANDERSON: Good afternoon, all.

We have a lot of material to cover this afternoon and a number of witnesses, and we'd better try to adhere to the schedule that we've established for ourselves.

I hope that this afternoon's hearings are as successful as the ones we had earlier. I thought that was very productive from our standpoint.

Is Mr. Paul Zintl here? Mr. Zintl is Managing Director, Administration and Finance of J.P. Morgan Securities, Incorporated.

Mr. Mark Holloway is Vice President, Operations Division, Goldman Sachs & Company.

We have labeled this panel "Credit Evaluation."

Thank you for coming gentlemen. Mr. Holloway, we will start with you.

STATEMENT OF MR. MARK V. HOLLOWAY, VICE PRESIDENT, OPERATIONS DIVISION, GOLDMAN SACHS & COMPANY

MR. HOLLOWAY: Goldman Sachs submitted a letter to the General Accounting Office on this topic, and I would like to draw from that a few comments that seem to be pertinent in the context of what was said this morning and the context of the topic of credit.

Goldman Sachs is a registered broker-dealer, as well as one of the Federal Reserve Bank of New York's 40 reporting dealers. In addition to being a dealer in Government and agency securities, the firm is a market-maker in corporate debt and equity and municipal securities.

Goldman Sachs is subject to the regulatory oversight of the Securities and Exchange Commission, the Federal Reserve Bank of New York, the Commodities Futures Trading Commission, and several foreign regulatory bodies. In addition, Goldman Sachs is a member of a number of self-regulatory bodies, including the NASD, the MSRB, the NFA, and all the major domestic stock and futures exchanges.

Goldman Sachs relies heavily on the blind brokering systems in connection with its Government bonds trading activities. Its importance to our firm rests in part on the confidentiality it provides traders that utilize the system, but these benefits and, as a result, the viability of these systems are primarily dependent on the creditworthiness of the participants in these systems. We use the term "creditworthiness" to encompass not only the capital and resources of the participant, but also the controls and other prudent management techniques they employ.

The brokering systems function efficiently and provide substantial liquidity to the Government securities market because participants are able to make trading decisions without focusing unduly on the financial stability and quality of their counter-party.

The General Accounting Office asked each of us to respond to a number of questions, and I would like to refer to just three at this point. All of these questions fall under the heading, "Trading Access."

The first is Question No. 1: How important is blind brokering for the efficiency and liquidity of the Government securities market?

In part, I have just addressed that. The blind brokering system is extremely important to the efficient functioning of the

Government securities market. Goldman Sachs' cash flow approximates $30 billion daily. An overwhelming proportion of this total results from our participation in the Government securities market. Our potential credit exposure is enormous. If we were to develop doubts about the creditworthiness of members of the system, it would have severe ramifications on our willingness to trade actively.

I will now deviate a bit from our written response, but I think that one distinguishing characteristic of the Government bond business, at least at Goldman Sachs and I think at some other firms, is the overwhelming impact it has on the broker-dealers' financial statements, as I have indicated. If you were to look at Goldman Sachs' most recently published balance sheet, it shows approximately $38 billion in assets. The overwhelming majority of those assets are a function of our participation in the Government bond business. We are in no other business that would impact our financial structure as greatly, and the concern about credit and liquidity obviously is in the context of that level of exposure, borrowing and hope for liquidity.

Question No. 2 is: What are the costs and benefits of the current system of limited access blind-brokering? We were focusing on the benefits.

The primary benefits rendered from the blind-brokering system, as currently structured, are the confidentiality of the trades and the comfort afforded by the assurance of the creditworthiness of the participants and the systems as a whole. Alternative arrangements could extend the informational area to a far wider universe of participants. Similarly, the trading privileges could be expanded, but only as long as high credit standards, coupled with appropriate monitoring of management procedures, are maintained.

The final question I would like to respond to is Question 6: For what reasons do you consider it acceptable or unacceptable for brokers to require new customers to first have a business relationship with the Federal Reserve Bank of New York as a primary dealer before it will consider the customer's application for access?

The relationship with the Federal Reserve Bank of New York is a factor that is extremely important because of the credit standards set by the Federal Reserve Bank and its monitoring of the activities of the reporting dealers. As a primary dealer, we have great confidence in the surveillance methods and the supervisory role undertaken by the Federal Reserve Bank.

The primary dealers must report inventory positions on a daily basis and are subject to spotchecks. These activities

afford us great comfort in the blind-brokering system as well, because we are sure that the participants have adequate capital and resources and are engaging in prudent business activities and exercising management controls.

That concludes my responses.

[See appendix V for the written comments submitted by Goldman Sachs.]

MR. ANDERSON: Thank you very much, Mr. Holloway. Mr. Zintl, please.

STATEMENT OF MR. PAUL A. ZINTL, MANAGING DIRECTOR, ADMINISTRATION AND FINANCE, J.P. MORGAN SECURITIES, INCORPORATED

MR. ZINTL: Good afternoon, gentlemen. I am the Managing Director in charge of Finance and Administration at J.P. Morgan Securities. I am here to share with you my views on the credit implications of the blind-brokering market among primary dealers.

The questions posed in the request raise broad and various issues, and you've grouped them into three general categories: one, trading and access; secondly, the informational access; and third, the utility of the brokering services in general. For the purposes of the Credit Panel, I would like to address only the trading access issue. I will not deal with the issues of information or the utility of the brokering services, since they fall outside the scope of this panel.

I will be answering some of the specific questions posed in the study in my prepared remarks, but I'd be glad to address any others afterwards in questions.

What are the risks and who bears them?

Simply stated, the risk is that when you conclude a Government securities trade in this blind market, you don't know who your counter-party is. You cannot be certain that he will settle the trade, and you have only limited ways of assessing that risk. It is axiomatic in this business to know who your counter-party is, and yet in this huge and very volatile inter-dealer market, we've abandoned this cardinal principle.

I'd like to take a minute to explain specifically what credit risk is on an unsettled trade in order to emphasize how important the knowledge of the counter-party is.

The risk that the counter-party will not perform is a market price risk that you have between trade date and settlement date. This period can be as short as one day or as long as two to three

weeks. For example, the Treasury will auction tomorrow a 30-year bond that has been trading on a when-issued basis since January 28th. It will not settle and be paid for until February 17th. That's a period of 20 days, and during that period, all parties to WI trades are exposed to counter-party risk, some of which is identified, i.e. those trades with your customers, and some of which is anonymous.

Last year, to make the example specific, when the Long Bond of November 2016 was first announced on October 29th, it traded on a when-issued basis of 7.62. One week later on the date of the auction, the bond traded on a when-issued basis of 7.57. In that week, it had appreciated by five basis points and some $290,000 in price on a $50 million trade. When the bond finally settled eleven days later, it was trading ten basis points lower in yield at 7.47 and higher in price by $590,000 on the same $50 million.

In summary, if you had bought $50 million Long Bonds from an unspecified counter-party in the dealers' market on the day the issue was announced and sold it to a client, you would have had exposure to an unknown counter-party on the day that the trade settled of some $880,000. If your counter-party had not delivered those bonds, you would have realized this loss by having to go out in the market and buy the bonds at the new market price in order to make good your delivery to the client. This is obviously an uncomfortable risk.

The inter-dealer market allows for unlimited trading with theoretically unlimited leverage between trade date and settlement date, which, as I said, can be up to three weeks long. Dealers can buy and sell securities for trading purposes without ever having to deliver or pay for those securities, so long as their positions are flat by settlement date.

As you know, roughly 50 percent -- or between $40 and $50 billion a day -- of this market trades between the dealers, mostly through the blind-brokering system, so the aggregate credit exposures are quite huge. The $880,000 exposure I used in my example represents a price move over the three-week period of about 1.8 percent. That is not particularly dramatic, but the amounts are large, and please note that there is no margin collected on this exposure at all.

Our business requires that we take this credit exposure from our customers without margin, and we monitor this exposure closely every day. The blind brokers' market requires that we also take this exposure to unknown individual firms within a closed set of counter-parties, and those are the risks of the system. They are borne first by the brokers and ultimately by the primary dealers themselves because of the limited capital that the brokers have. These risks have and will continue to

increase with the number of dealers in the system and with the volatility of the market.

We think it quite acceptable and appropriate that the brokers require new customers to be or aspire to be dealers, primary dealers, as designated by the Federal Reserve Bank of New York. Having this relationship is, to us, a more important status than simply aspiring to it because of the regular supervision and the required daily reporting of all positions held by primary dealers. While we do not take as much comfort in the simple aspiration to be a dealer, we nonetheless find it acceptable, albeit not sufficient, because the stated interest to become a dealer implies a public commitment to maintain the standards required by the Fed and because this counter-party will begin reporting daily to the Federal Reserve when the Fed thinks it appropriate, and finally because the firm will likely become a primary dealer before or by the time that their trading activities become a significant part of this inter-dealer market.

So while we do not rely on the certainty of the business relationship with the Federal Reserve Bank of New York, we do rely significantly on the supervisory and the reporting relationship, legislative or assumed, that the New York Fed has to patrol this beat.

In our view, the credit risks to the system were expanded when access to the brokers' market was widened to include non-primary dealers who aspire to become such. The credit risks to the system would be even more severely strained if trading access were expanded again.

The individual risks posed by certain well-capitalized and well-managed firms are probably not great if they get access to the system, but credit judgments are highly individual and relative decisions. If the system is to be effective, it must remain closed, at least so the participating dealers remain confident of the system's credit, and this confidence is a big part of the system.

If you do not limit admittance at this particular line -- which some may consider artificial -- it will be extremely difficult to find another appropriate place to draw it. At some point in this expansion process, the credit risks will become too uncertain, too uncomfortable, and there will be some impact on the liquidity and the efficiency of the market.

Other panelists this afternoon will discuss with you what those consequences for market liquidity and efficiency might be, but I would suggest that such an expansion would, at a minimum, require a significant increase in the capital of the individual brokers, because they do have some risk as principals, i.e., as

agents for undisclosed principals in these trades, and because such an expansion would make this fact more evident.

The development of a guaranteed settlement system, open to a broad range of institutional participants, could also help ease the credit risks in an expanded market. How and/or whether an industry clearinghouse might be able to provide this guarantee cheaply and efficiently is another question, but it is important to avoid building a system that spreads broad risks of loss to its users and thereby provides incentives to the largest and most well-capitalized players in the market to deal outside the system.

To summarize, let me say that the current system of blind brokering among the dealers has significant risks. It is principally the risk of granting unmargined credit exposure to unknown counter-parties. These are risks that are unacceptable to all these same dealers in other markets.

The risks are tolerated, one, because there are a limited number of counter-parties, or potential counter-parties, in the system; two, because of the capital strength of most of the primary dealers and, as importantly, because of the reputations and longstanding commitments of the dealers to this market; three, because of the role of the Federal Reserve Bank of New York as supervisor on a day-to-day basis of the primary dealers in the market and as a prospective supervisor of the aspiring dealers; and four, and almost most importantly, because of the willingness of the primary dealers in light of these other considerations and because of the importance of the anonymous trading to grant this unmargined exposure to unspecified counter-parties.

I would urge the GAO not to recommend to Congress changes in this inter-dealer brokers' market that would serve to increase these risks, and I would give similar counsel to the Treasury as it prepares its regulations under the Government Securities Act of 1986.

The system is already too loose, in my view. It bears credit risks that are larger than it should, in theory, be capable of. If you change it, you should do so only with the intent of decreasing the risk and of increasing the confidence of the dealers using it.

If I might, Mr. Anderson, I'd like to also address four points, since you asked that we direct our remarks to either the responses that were made to the GAO's circular or to the comments made this morning. Four things struck me that I'd just like to mention.

One, if you do expand the system and have a general clearinghouse that might be limited by brokers maintaining high credit standards for participants in the system, please recognize that brokers, in doing that, would be dealing with their customers, and brokers typically -- and you might talk to the brokers about this -- will generally have very little leverage on their customers. We find the same thing to be true in our business. We don't have as much leverage with our customers as we'd like.

The history of financial problems consistently shows that people's good business judgment can often be swayed when they don't have leverage in a business relationship.

Secondly, the point was made this morning that the brokers must be doing these kinds of checks now. I'm sure that they are. We feel, though, that the system is too important and the exposures are to large to leave it in the hands of the brokers alone. The point was made that all traders in all shops have position limits, and controls are very good in trading rooms of major dealers. That's simply not the case.

It is the case that, in theory, all traders have limits. The things that Mr. Holloway referred to, though, about management controls, experience of traders, integrity of management, these are the kinds of things that we think are important and the things, from experience, that the Federal Reserve Bank of New York looks at and which I would urge you not to ignore if you do decide to alter the system and simply put a large capital requirement on participants in it.

One other thing on that is longevity of people in their jobs. There is high turnover in this business, and the controls that one dealer might have one year just might not be there the next, if they're suffering from turnover.

Lastly, although I've emphasized the when-issued period in the Government securities market as the time when you're exposed to most credit exposure on unsettled trades, I don't want to ignore the risk in a regular trade which settles on the next day. You can make a trade on Friday morning before an important economic number is released, and you don't settle that until 5 o'clock Monday afternoon, and as you know from observing the volatility of the markets, a lot of money can be made and lost in that period, and realistically you wouldn't even know of it and be able to do anything about it until Tuesday morning.

Thank you very much.

MR. ANDERSON: Thank you, Mr. Zintl. We'll start the questioning again with Mr. Simmons.

MR. SIMMONS: Mr. Zintl, I guess you feel that we have drawn the line or we've gone as far as we can go in terms of drawing the line and perhaps it ought even be pulled back a bit because you are worried about the expanding credit risk in the market. Is that correct?

MR. ZINTL: Yes. I mean no official line was ever really drawn. It used to just be that you had that relationship and understandably over the past four or five years it has gotten looser and looser understandably because it's a very unofficial thing.

MR. SIMMONS: Mr. Holloway, you seem to indicate that if you can find a means of assuring creditworthiness, as you have defined it, that perhaps we could expand access. One might argue that if everybody had to adhere to the same creditworthiness standards under Mr. Zintl's logic, you might see a shrinkage in the number of people with access to the screen.

At any rate, we heard a lot of talk this morning about the fact that it shouldn't be too hard to establish creditworthiness standards. I didn't hear much in the way of specifics on what they ought to be; who ought to be establishing them; and who ought to be monitoring credit risk in the market, and I wonder if you could provide more information and offer your views on what those standards ought to be and what kind of monitoring ought to be involved and who should be doing it?

MR. HOLLOWAY: I'd like to return as a preface to my response to the comments I made about the size of the dollars involved for Goldman Sachs as well as for a number of other primary dealers. I don't think we are the largest by any means, so liquidity and strength of the marketplace is very, very important, and measuring the participants is critical to this kind of a firm.

As I indicated, we are regulated by a large number of people already and I don't know that I can tell you which of those many bodies is more able to regulate us than another one or to make that determination, and I'm not really in a position to pick among the various regulatory bodies and say it should belong to you or to another body. But we do take a lot of confidence in the Fed and in the idea that each day they see the positions that Goldman Sachs has. They see the volume that we have been generating by type of security.

It gives them an opportunity to develop a profile of the firm. They talked to the people who conduct Goldman Sachs Government bond business so they know the firm more than just

through pieces of paper. And, I think that kind of monitoring is an important adjunct to the types of responsibilities we have to the Securities and Exchange Commission and to the CFTC and a number of other bodies. I mean, in effect we are telling the Federal Reserve every day a lot about our balance sheet.

We are telling them pretty much on a daily basis what the bulk of our assets structure is and I think the level of comfort that I referred to is derived from there and somebody establishing objective standards in our view should include that type of monitoring.

I am not saying you should do all the same things, in exactly the same way, or what have you, but we view that level of familarity, as very helpful.

MR. SIMMONS: Let me just follow up very quickly. So, I think I heard you say that you do feel that the business relationship with the Federal Reserve is important in monitoring creditworthiness. I think I heard you say that, the fact that you do transactions with them.

MR. HOLLOWAY: Yes. I think more specifically though I was making reference to the fact that they call for that information that we send them. It's not just a matter of a piece of paper that goes to the guy's desk and gets filed in 18B and never emerges, they've taken an interest in the information that we give them.

I'm not qualified to discuss the business relationship that Goldman Sachs has but from the regulatory point of view, I would say that they pay attention to us in a fairly serious way. We derive comfort from that.

MR. ZINTL: May I just add that I don't know if I left you with the impression that I do not want to restrict or to close down further the access to the screens. All I was saying was that I think it is a bottomless limit and if you are going to do anything with it you probably ought to formalize the kind of thing that's going on now with the New York Fed if you are to expand it any further. I don't want to cut people out of it or anything.

MR. ANDERSON: Mr. Thieke?

MR. THIEKE: Paul Zintl, you noted that the risk in terms of counterparty credit risk can get substantial particularly during when-issued trading periods. There are conventions in other

markets involving forward trading. Many of those conventions are associated with the existence of central clearing corporations which do provide mechanisms for periodically marking those positions to market and establishing some measure of reserves associated with exposures. Do you see a market interest in developing such a mechanism within the Government securities market and if it were to develop, how beneficial would it be from the point of view of an additional degree of restraint on the size of potential credit exposures that could develop during these trading periods?

MR. ZINTL: You are probably aware that the National Securities Clearing Corporation is looking at developing a central clearing house now. One of their proposals would be to net, and that would eliminate a large volume of the exposure. I do think there is probably an interest in the market in doing it but it faces some problems.

First thing you have to do, as some of the brokers commented in their responses, is to require mandatory reporting of all trades on trade date so that you could check the trades out and have an automated procedure for knowing of any out trades immediately upon trade date.

And then you would have to collect margin because in preparation for this visit I looked over our exposures and on the days closest to settlement of when-issued trades they're significant with individual brokers and with individual counterparties. So you have to put in places a margin system, similar, I guess, to what you have on the futures exchanges. And, yes, that would greatly reduce the risks on settlement.

MR. ANDERSON: Mr. Bremner?

MR. BREMNER: I'd like to toss in a slightly different question. So far all the comments dealing with credit have dealt with the credit evaluation of the dealer and everyone else is asking those sorts of questions. I was curious as to the credit evaluation of the broker. What sort of process is used there?

MR. ZINTL: We go and visit the broker; sit down and talk to him about what is changed year-to-year and then try to go through how he runs his business essentially, just to be sure that he seems to be in control of it. Brokers say they are not taking any trades as principals. You want to see that they're operating their business and stand there on the floor and watch them do it to see whether they are not doing that, and then you also look at their capital structure. I believe I'm correct in saying that it has been increased significantly over the past few years which is appropriate. So, we look at that and we have lines set with brokers. I can't tell you what we would do if we got over that line simply because the brokers' market is such an important part

of your dealing. But we do watch that, how much exposure we have to any one broker and we try to visit them every year.

MR. ANDERSON: Mr. Becker?

MR. BECKER: With respect to the interrelationship between confidentiality and creditworthiness, the argument that you need to have assurance as to creditworthiness then ties back to the New York Fed.

It seems to me that there is another aspect of business relationships here which is the business relationships that both of your firms have.

You both indicated in your written or oral statements that there may be additional firms outside of the primary dealers that are creditworthy and that could be included in the system. The focus this morning was on having the brokers' brokers make that judgment. Would your firms be capable of making that judgment? In other words, turning it in on itself, would your firms be willing to indicate to the brokers' brokers those firms in addition to the primary dealers that you were prepared to deal with?

MR. HOLLOWAY: I think the firm is in a position to evaluate other dealers from a standard credit point of view and certainly can offer judgment as to which firms would appear to be the most creditworthy by whatever standards one wanted to use. I think though that it would be unlikely that any firm could do anything like the kind of evaluation that would replace the relationship with the Fed.

For example, I don't believe any firm would want to send us their positions for a month to let us get a glimpse of how prudent they manage their business so that we can pass that judgment.

MR. BECKER: Well, presumably your firm does deal with non-primary dealers in this market?

MR. HOLLOWAY: Yes.

MR. BECKER: And, presumably you're making judgments when you enter into those business relationships on a regular basis?

MR. HOLLOWAY: Yes.

MR. BECKER: Taking that relationship and that credit evaluation and transferring it into the blind brokering aspect, the argument that is being presented is, I don't want to have to trade with somebody I don't trust. Can you identify

those individuals you're prepared to trade with. Your written comment indicated that there were additional firms that you thought were creditworthy. Without naming names, Lazard strikes me as a firm, at least, that was here this morning, that Goldman Sachs is willing to trade with. Can you identify those firms?

MR. HOLLOWAY: Yes, I was responding in a sense of a generalization. You could give somebody a list of the firms that you would say that I think these guys are all terrific and they pass our credit test. I'm further saying that I don't know that you would have anywhere near as much confidence in those evaluations as you would derive from that dealer having a relationship with the Fed and therefore you might think more restrictively in terms of the types of limits you would set for that broker or dealer. That was my point, not that you would say that you won't do business with so and so or what have you. I think that the blind brokers, as has been implied here, receive, in effect, a very high credit rating because of this relationship.

I think that one could say that if the broker system contained a number of names that were not subject to that scrutiny one might diminish the credit rating that you had assigned to the broker system. But yes, you are absolutely correct, you can make a judgment as to who you would put into the A pile, the B pile, the C pile and the D pile. But I don't think people would believe that would be a straight substitute for that kind of a relationship.

MR. ZINTL: If I could add to your question, Mr. Becker. Although we could do that, that would hurt liquidity for two reasons. I don't think technologically the brokers can have up on the desk of the fellow that covers us just the names, just bids and offers from the names that we will deal with. And secondly, if I call the broker and decide to hit a bid, I can't have him coming back and telling me that I can't deal with that name. So that would hurt liquidity and this happens once a week in other markets where we trade, in the money markets, for instance, where traders had sold something and brokers come back and said you can't do that name. The Treasury market just moves too fast to have that kind of credit check behind the trading.

MR. BECKER: Thank you. At the risk of beating a dead horse, the thought is that if you were inhibiting your displays of your bids and offers so that you would only end up trading with a firm that you were comfortable with, that you would have both achieved the creditworthiness assurance that you're looking for as well as maintaining the confidentiality within the system, so that the only thing that the broker is doing is providing you an intermediary to ensure that your bids and offers are only being taken, as it were, by firms that you are comfortable dealing with, so that rather than

having to depend upon a third party such as the New York Fed giving you that assurance, you could make that individualized judgment yourself. And you are saying that as a practical matter that won't work?

MR. ZINTL: Exactly. Because if I'm comfortable dealing with X, Y, Z on the first day of the when-issued period, by the seventh I might not be. And my exposure to him will go up and down with the market. So if I've allocated that I can take up to ten million of exposure on unsettled trades to this person and we have a big market move, a minute later, I'm over my line with him. And as I said, there is one market out there. I just don't think they can fragment it that way, but I would defer on that to some of the brokers as well and to some of the other people you will talk to this afternoon.

MR. SIMMONS: Let me make sure that I've got this straight. Are you saying that you cannot tell a broker that you are uncomfortable with a certain dealer that has access to the screens and ask that broker not to execute trades where the counterparty is the firm you are uncomfortable with? Is that what you are saying?

MR. ZINTL: One broker has done that but in general the response is even from that broker, we can't do this often because we can't handle it, and I don't believe the other brokers do that. You should address that to them. I don't think they have the capacity to do that. On one brokers' list, there are one or two names that are asterisked as being restricted.

MR. ANDERSON: Mr. Swaim, Mr. Zacharias, do either one of you have anything?

MR. SWAIM: I have one question.

MR. ANDERSON: Yes. Mr. Swaim.

MR. SWAIM: I wonder if the panel could cast some light on the problem that the Fed or anybody else faces. If you are just looking at exposure in the Government securities market and you don't know what other exposures the firm might have in the foreign exchange market, or stock market or some other market, and if we are talking about a capital adequacy guideline for capital committed to the Government securities market, what kind of mechanisms do your firms have or what other arrangements would you need to have to access the total exposure of a firm rather than just concentrating on the Government securities market itself?

MR. HOLLOWAY: We have a system and really it is quite complicated, that summarizes on a daily basis all the exposures that we have, versus, I think, virtually every counterpart but certainly every counterpart bigger than a certain level; it values each type of exposure for what we think a maximum loss for that type of exposure could be.

For example, earlier this afternoon Paul diagrammed a loss on a forward trade for you and what had happened over, I believe, it was a two-week period. We would look at forward exposures with an individual counterpart, foreign currency, Ginny Mae, precious metal, whatever they would be, and assign a weight in recognition of the type of loss that Paul described. We would assign a weight to fails which should have been delivered to us or vise versa which haven't been delivered yet as well as to just open inventory positions.

We accumulate a number each day, a gross number, and those are awful, a gross number and a net number. A net number representing what you would expect to lose, that includes all of these risks.

MR. ZINTL: If I could just add to that. We do a similar sort of thing but each market area is allocated a certain line for a counterparty. And those lines add up to the total exposure that the firm is willing to take to that counterparty.

But the important thing in evaluating credit is not capital. Capital in these markets, I don't want to be dramatic about this, but it could be here today and gone tomorrow, its one of five ingredients. Much more important things are experience, management controls, integrity of the institution and its profitability, and that has got to be established over a period of time. It just can't be bought with huge excess capital. It is just that capital is one thing.

MR. ANDERSON: Thank you. I think we have just about used up the time, unfortunately.

Mr. Holloway and Mr. Zintl, thank you very much. It has been our pleasure. We may have some additional questions either in writing or by phone. Thank you.

Our next panel consists of a group of brokers. Mr. Fox is counsel of the Government Securities Brokers Association. Mr. Geng is President, Fundamental Brokers Institutional Associates. Mr. Peter McKay, Managing Director, RMJ Securities Corporation, and finally, and forgive me if I pronounce it wrong, Michael Franzese, President, MKI Government Brokers. Welcome, gentlemen.

Mr. Fox, we will start with you and move down the row.

STATEMENT OF LAWRENCE I. FOX, COUNSEL, GOVERNMENT SECURITIES BROKERS ASSOCIATION, ACCOMPANIED BY EDWARD GENG, PRESIDENT, FUNDAMENTAL BROKERS INSTITUTIONAL ASSOCIATES; PETER H. McKAY, MANAGING DIRECTOR, RMJ SECURITIES CORPORATION; MICHAEL F. FRANZESE, PRESIDENT, MKI GOVERNMENT BROKERS

MR. FOX: Thank you. Mr. Chairman and members of the Panel, my name is Lawrence Fox and I am counsel to the Government Securities Brokers Association, which is a national trade organization representing interdealer and retail brokers of Government securities.

On behalf of the Association, I would like to express my thanks for this opportunity to present the membership's views on the important issues under your consideration.

I would like to preface my remarks by noting that the questions raised by the General Accounting Office involve significant competitive and commercial judgments that most properly are answered by each broker individually, based upon its own views of the marketplace. Consequently, my comments today and those submitted previously by the Association, are intended to represent a composite of the views held by the Association's members, and do not represent the specific views of any single broker.

An issue upon which there is complete agreement is the entire membership strongly believes that any changes to the existing system must be considered with caution and restraint. The necessity for care is compelled by the complexity of the issues, the lack of sufficient historical data to predict the impact of any proposed changes, and the sensitivity and global importance of the Government securities' market.

The Association was formed in April of 1986 to provide a forum for the discussion of issues central to the efficient functioning of the Government securities' industry. One of its principal activities is to present the views of the interdealer and retail brokers to regulators and to the financial community. Today, the Association's members account for more than 90 percent of those transactions executed through securities' brokers.

In fact, approximately 50 percent of the average $100 billion worth of Government securities traded each day by reporting dealers is transacted through interdealer brokers. Interdealer brokers, sometimes referred to as either screen or blind brokers, perform a crucial role in the smooth functioning of the secondary market for Government securities. The importance of the interdealer market is underscored by the considerable size of today's U.S. Government securities' market.

In 1985, the Treasury raised a total of almost $1.2 trillion from the auction market in Government securities to finance the budget deficit and re-finance maturing debt.

The ease and speed of executions in this highly liquid market is unmatched in the world. It is the brokers who provide the critical elements of speed and confidentiality which are the factors that produce this market's unparalleled depth, liquidity and efficiency.

The issues of broadening access to the interdealer network is a highly charged and controversial one, because in great part, it is widely believed that expanded access will have a direct effect on the speed and confidentiality associated with executing Government security transactions.

Those who favor maintaining the current system of limited access argue that it is not unduly restrictive, it is narrowly designed to ensure the creditworthiness of system participants, and promotes the market's liquidity, depth and efficiency. The proponents of this view argue that designation by the Federal Reserve Bank of New York as a primary or aspiring dealer is the most historically reliable criteria for creditworthiness, because of the oversight and monitoring functions performed by the bank, and that expanded access to non-reporting dealers will endanger the reliability of the system by injecting uncertainty about the financial strength of new participants. This uncertainty will cause them to reduce their involvement in or trade outside the system, which would impair the efficiency of the interdealer brokering network and an impaired interdealer market would, the argument continues, directly affect their ability and willingness to perform their market-making functions and assist the Federal Reserve system in implementing its monetary policy through its open market operations.

Adherents to the present system further note that there is no unfair advantage because non-reporting dealers can trade through retail brokers and have access to interdealer quotations through available information sources. This lack of advantage is reflected in the narrow margins between the so-called inside market price and the price available to those dealers and investors outside the interdealer network.

Finally, it is argued that expanded access could increase transaction costs, and decrease customer service, because, one, brokers and dealers would incur costs associated with developing a separate credit monitoring capability. Two, interdealer brokers would be subjected to increased capital requirements necessary to assume credit responsibility for transactions executed through their system. Three, the size of transactions would shrink, thus, the average cost per million dollars of Government securities traded would increase.

Hence, the proponents of maintaining the status quo conclude that any marginal benefits of expanding access would be far outweighed by the risks that such change would pose to the entire brokering system, which lies at the very center of the Government's ability to finance its ever increasing debt.

Those who favor expanding access, on the other hand, argue that the current limitations are arbitrary, unfair and reduce the liquidity and depth of the securities' market. They argue that first, limiting interdealer participants to reporting dealers is arbitrary and is not solely based upon concerns of creditworthiness. Second, there are adequate means available to assess and monitor the financial responsibility of investors and dealers who wish to obtain access to the system. Third, that the current system has placed them at a competitive disadvantage and hence, has increased their transaction costs in the form of higher commissions and lost sales.

Hence, the opponents of the existing system conclude that their exclusion has reduced the breath and depth of the Government securities' market, thereby increasing the overall cost of issuing and selling the Government's debt instruments.

On the other hand, the addition of a greater number of creditworthy participants, they suggest, would narrow spreads and liquidity and decrease transaction costs, and thus, enhance the efficiency of trading Government securities.

At this juncture, it must be emphasized that the actual impact that an expansion of trading and information access would have on the secondary market is a matter of speculation, because there is simply inadequate data available to evaluate the effect that such a change would have. For the most part, the Association's members believe that the current system functions extremely well and represents a safe and efficient mechanism to accomplish speedy and confidential Government securities' transactions.

However, this is not to suggest that limited changes which are well conceived and implemented incrementally may not result in marginal increases in the liquidity and market efficiency. If, for example, a mechanism were devised whereby customers with trading access to brokers' screens were sufficiently creditworthy, this could work to eliminate concerns by others that utilize the blind brokering system, that risk would not in fact exist. Expanding the number of participants in the system while maintaining efficient markets would likely increase the depth of the market in each Government issue and reduce the price spreads on those issues. This would decrease price volatility and enhance investor confidence and improve the ability of the Government to fund its debt.

On the other hand, if expanding market access resulted in reporting dealers having less confidence in the financial integrity of the system, they may reduce or abandon their use of the brokering system. This would diminish greatly the utility of the screen brokers, thereby increasing inefficiency, adding transaction costs that otherwise would not have existed, and ultimately, significantly impairing the liquidity in the market.

In sum, any alternative to the existing system that would have the effect of impairing the confidence and integrity of the brokering system would most likely have the effect of increasing the cost of issuing and selling the Government's debt instruments. Thus, great caution should be exercised when considering any mandated changes. When considering whether any alteration to the existing system should be imposed by regulation, it should be kept in mind that the brokering system has never been a static one, but rather has been dynamic and has evolved and changed in response to technological innovations and market forces.

Consequently, many brokers believe that the issue of expanded access should not be resolved by the imposition of any change, but rather, should be left to the unencumbered interplay of market forces.

I am pleased to have seated next to me today, three eminent members of the Association and the brokering community, Mr. Edward Geng of Fundamental Brokers; Mr. Peter McKay of RMJ Securities; and Mr. Michael Franzese of MKI Government Brokers. Each of these gentlemen has enormous breath of experience and knowledge concerning the secondary market for Government securities and can assist the Panel in answering specific questions relating to an individual broker's view of the likely effects of any changes in the existing brokering system.

If the Association can be of any additional assistance to the General Accounting Office or any members of the Panel in connection with its study, please do not hesitate to call upon us. Thank you for your time and consideration.

MR. ANDERSON: Mr. Fox, do I understand that the other Panel members will not have individual statements to make but merely support you in questions?

MR. FOX: Yes, sir.

[See appendix VI for the written statement of the Government Securities Brokers Association, appendix VII for RMJ Securities Corporation, and appendix VIII for Fundamental Brokers Institutional Associates.]

MR. ANDERSON: We will start the questioning again with Mr. Simmons.

MR. SIMMONS: Mr. Fox, you indicated in your statement that some of the dealers had extended their screens to their customers. Mr. Stout of FBS said that that screen is not the same screen, that it is not the brokers' screen, that is something else. Can you comment on that?

MR. FOX: I think I will defer to Mr. Franzese on that question.

MR. FRANZESE: Some of the dealers take a live broker feed of our prices and pass it to their branches who in turn pass it to some of their accounts, ala the Blumberg system. Some of them mark it up and down. It depends on the individual dealer and the mechanism he is using to spread the market. The only system that I am aware of that uses probably live broker prices other than Telerate is the Blumberg system, which has passed it on to several institutional customers of Merrill Lynch.

MR. SIMMONS: What is the difference between what is shown on that system and what your customers see? Is there any difference?

MR. FRANZESE: I don't believe so, sir.

MR. SIMMONS: Thank you.

MR. ANDERSON: Mr. Thieke. I'm sorry. Mr. McKay wants to add something to that.

MR. McKAY: Perhaps we could clarify a little bit. One of our competitors, Cantor-Fitzgerald, who has been referred to as the retail broker here, is indeed a formidable competitor and its prices are disseminated widely through the Telerate system. Several people today have spoken of that as not being the inside market per se. However, I think if the Panel will check more carefully, they will find that the prices on Cantor's are quite close if not the actual market and secondly, they command a much larger share of the market than is widely known.

The information that everybody believes is not available, although it may not be available to the fullest extent, is available to a greater degree than I believe most people realize.

MR. ANDERSON: Thank you, Mr. McKay. Mr. Thieke?

MR. THIEKE: I have a question that concerns the potential impact on the usefulness of the information that is on those screens, were those pictures to be shown for informational

purposes more broadly. A number of the witnesses this morning mentioned they thought that would be a beneficial development in terms of a broader distribution of information of where market prices were being quoted.

I am wondering if one broker, let's say it is broker A's screens, were to be available in that fashion through a typical service, whichever information services are available, but the other brokers' screens were not. In your professional opinion, would that affect the quality of the pictures that were shown in one of those screens as compared to the others, thereby diminishing the ultimate value, if you will, of the information that is being distributed more widely.

Stated differently, would you have to mandate that every broker show their screens in order to maintain a degree of competitive quality in an environment where those pictures were shown for informational purposes more broadly.

MR. GENG: I think it is very possible that if one broker were to provide the information currently, that some of its customers might object to that. There has been a question raised in the course of the discussions this morning and ongoing as to the legality of who is the owner of the quotations. Obviously, there is a dispute among the parties involved as to who the owners are. In any event, if a broker were to publish those quotations, they would obviously run the risk and some of their customers might be less willing to show pictures. I don't think we can answer that in a vacuum. I don't think we can make that judgment.

Frankly, as Peter McKay mentioned earlier, I think the availability of market price information is much greater than some would suggest, both through the Telerate Cantor screen and through quotations that are published through various media services on specific bids and offerings by individual dealers. There is a wide body of information that really is closely comparable to that which appears on the interdealer brokers' screens.

Personally, I think it is very possible that wider access to the information could be made without detriment to the marketplace, but obviously I think we do have to face up to the issue, as to what impact that might have on any individual firm that might choose to take that course of action.

MR. ANDERSON: Mr. Ketchum?

MR. KETCHUM: Mr. Geng, if I could take advantage of your wide experience both on the Fed side of things as well as in the industry, I would appreciate understanding basically two parts of one question. First, for Fundamental or for other brokers'

brokers, to the extent that you know, what type of credit analysis do you perform over and above the fact that a firm is a primary dealer now? And secondly, were you to consider expanding the number of firms beyond the primary dealer and aspiring primary dealer level, what types of credit analysis and what types of standards do you think would be appropriate for you to put in? Have you gone down to the point of thinking what specific pieces of the puzzle you would be looking at?

MR. GENG: To answer the first part of the question, I can only speak for Fundamental Brokers, but we have relied, as I believe others have historically, on the Federal Reserve's published list of primary dealers as the main basis for selection of our customer base, I think for two basic reasons. That is the one clear, objective means that seems to be acceptable to our customers, whose confidence is a prerequisite to the functioning of our marketplace.

I think from our viewpoint, we supplement the use of the Federal Reserve's list of primary dealers and the indications of those who are aspiring dealers with a credit service which evaluates each of the customers that we are to take a business relationship with. We also obtain from new customers, obviously, preliminary credit information as a basis for forming our original judgment. But given the quality of the customer list that we begin with, certainly we have not felt it necessary to have an elaborate credit mechanism.

On the second part of your question, if we did consider a widened customer base, I think it raises a large number of questions. I think some of the questions that arose this morning related to what methodology one might use if one were trying to establish a mechanism other than utilization. The Federal Reserve's designation is the method of determining access to the marketplace.

I think in my own mind I find it very difficult to envision a system of access in the present context of brokers acting as agents on an undisclosed basis where the brokers individually make credit judgments that would be acceptable to all the other counterparties in the system. I think this issue has arisen this morning.

I think if there were to be some different basis of selecting firms for access to the market, it would be very important that there be some independent third party, if not the Federal Reserve, then perhaps the Treasury or some outside party that would be acceptable not only to the brokers who services they would utilize, but obviously to all of the other participants in the system. Without confidence and agreement among those who participate, the brokers market simply cannot

function. The blind brokerage system cannot function without uniform agreement.

I think that answers your question.

MR. KETCHUM: To understand that last statement, do I understand that to mean that you would not find it feasible to provide a capability for a particular firm to indicate that they do not wish to trade with another firm in your system or that they wish to put a certain cap and have you build in an algorithm as to the maximum amount they would trade with that firm on a daily basis?

MR. GENG: I think if you were to come and visit one of the brokers' broker's facilities during the course of a heavy trading day, you would see how difficult it would be to impose restrictions on trading in the marketplace and what an impact that could have on the speed of execution and the ability to trade the volume of securities traded. I think it is an impractical solution and one that would be a detriment to the efficiency and liquidity of the marketplace.

I don't know whether any of my associates have other comments on that.

MR. ANDERSON: Let me break in for just a second, if I may. I am informed that some of your voices are not being picked up that well. Would you pull the mikes closer and lean into them, please. Thank you.

Please, Mr.McKay, proceed.

MR. McKAY: Our function in the market is speed, liquidity and anonymity. There was a suggestion presented before that the way to increase participation in the market would be purely through a credit restraint in position of credit and a monitoring of that credit by the broker or some other mechanism so that individual parties could, so to speak, get to their limit and that would be the end of their exposure.

In reality, something like that, although technically possible within the systems that are employed or systems that could be employed, does defeat the three purposes in life that we exist for. It would definitely slow down the process. It would definitely, therefore, hinder liquidity. If you just think about it in this context, our trades proceed to the best price at the quickest speed. If anybody in that process is one of the counterparties which is unacceptable, it then disavows that particular trade. The liquidity is impaired.

Just think about it in this context. Our trades are executed and completely disseminated to all of our customers

in one-tenth of one second. Anything which impairs on that would be a detriment, at least to our system, and most of our competitors are in the same bracket.

The third is anonymity. If there are lists prescribed by individual customers which put a restriction on this particular customer for this security, this restriction for that security, you could in a reasonable period of time detect who the counterparties were by the broker basically busting the trade after the fact, and therefore, people would be revealing not only their trading strategies but perhaps what their positions happen to be.

So I think, although conceptually that appears to be a nifty solution to the situation, in a practical world I don't think it works.

MR. ANDERSON: Thank you. Mr. Bremner?

MR. BREMNER: Some of the comments that have been received have revolved around the concept of a club atmosphere or club environment, and I wonder if, with the three representatives here, this might not be an opportunity to respond to whether or not there is competition between the interdealer brokers, and then whether or not there is competition between the interdealer brokers and the brokers who are not exclusively dealing with the primary dealers.

MR. McKAY: The brokers' brokers have been in existence for approximately 20 years. There is fierce competition among them, as evidenced by the fact that the Association was only begun several months ago. That is the first time that this collective body has been put in one room and not self-destructed. So yes, it is a fiercely competitive and cut-throat business. It is a club in some sense insofar as most people who are engaged in the securities business know each other. In that regard it can be referred to as a club, but in reality, when you go in the door at 8 o'clock in the morning, you are there for your firm and you are there to compete against the other guy, period.

MR. FRANZESE: There is a limited amount of people, brokers, limited amount of accounts that we are competing for, a volume of business, and as the industry has demonstrated in the last ten years, commissions have dropped drastically on a competitive nature to try to get a market share.

MR. FOX: Let me just comment also that you have recently a new entrant into the brokering business, and one of the earmarks of a competitive environment is the ability to have new entrants, in addition to the fact that you now have a higher volume of trading going on and a reduced commission rate, which is also indicative of the highly competitive environment.

MR. McKAY: You used the word "club," which has been used to refer to this group several times. It may be interesting to point out that there are more than one criteria used by at least our company in the evaluation of a customer. First, of course, is credit, and everybody principally uses the same criteria because the Fed has evolved as the only consistent body that we have looked to. However, in our particular firm we refer to the personnel within the dealer firm as importantly as we refer to the credit of the firm.

We refer to who the people are, what our experience has been with them in a trading capacity, their professionalism and their trading integrity. That is a very important thing to us. Equally important is the philosophy of the firm that they work for. Is that firm going to be a firm that has a mental approach towards this business, which means that they will trade. If all three of those, in our opinion, aren't really met, we are not sure we want them as a customer: (a) credit, (b) the integrity of the personnel in the shop, and (c) the philosophy of the shop.

I think that was touched upon slightly by the gentleman that preceded us on credit, but I think that is a point that should be pondered a little bit more. It is not purely a credit criteria; it is are you comfortable "knowing" your customer, are you comfortable dealing with the firm and with the people at the firm.

MR. ANDERSON: Any other comments, anybody? Mr. Bremner, do you have anything else?

MR. BREMNER: No, thank you.

MR. ANDERSON: Fine. Mr. Becker?

MR. BECKER: If I can come back to the credit determination, it seems to me that there are four entities that can make that. There is the New York Fed by a surrogate list; there is the brokers' brokers, and they are doing that based off the New York Fed; there is the firm itself, the primary dealer, who could make that judgment; or there is a fourth entity, some regulatory or rulemaking body to which people could report to.

With respect to the primary dealer making that judgment itself, what I have heard is that you can't have that firm making it because it will be impractical in terms of the size and volume of trading. I would appreciate it if you would go back and unbundle that a little bit for me. If I am not in the system today and I am allowed into the system recognizing that sometimes when I try and hit their bid or offer, I am going to get a reject in a tenth of a second because I'm not on an approved list, from where I sit I am still better off.

If I am a primary dealer and I am given such a list and I have decided to let a few firms onto my list that are not otherwise primary dealers and I send in an order to hit one of their quotes, in a tenth of a second I find out that I already decided I didn't want to deal with that party. Well, that is good news for me. I didn't want to deal with that party.

If I did want to deal with that party and I was going after their quote, have I contributed to liquidity? I am not trying to make that sound like such a black box alternative, but I am trying to say I don't see how either side gets hurt.

MR. McKAY: No. The current system works within the timeframes I described. Once you impose an architecture upon each system, which technically can be imposed, you slow down the process. Instead of going in fractions of seconds, my opinion is you go into definitely seconds and possibly minutes because you slow the architecture. The systems do not check individual credit limits, do not check by issues, do not check the creditworthiness; they simply execute the trades. You are imposing a superstructure upon the system which will by necessity slow it down, and I believe significantly.

MR. BECKER: From tenth of seconds to seconds.

MR. McKAY: To minutes.

MR. GENG: To minutes.

MR. FRANZESE: Or longer.

MR. BECKER: It keeps getting longer.

MR. McKAY: Even if it is seconds, it is --

MR. BECKER: Well, that is an order of magnitude of tripling the time.

MR. McKAY: It is significant.

MR. FRANZESE: It would probably be even longer. If you came to any one of our shops, each entity is broken down by type of instrument. You have a bill department, a coupon department, broken down by maturity, a long bond department, intermediate, and an agency. Each one trades independently of each other. In order to do the credit evaluation you suggest, we would have to have a consolidation point to get every trade on line up to the second with every department into a black box and come back out with a net position or net credit with each of the participants in the system. It is impractical.

About four or five years ago the Ginnie Mae market had a similar type system. It was a question of credit with the participants in the system. The system did not function.

MR. ANDERSON: Mr. Simmons?

MR. SIMMONS: I would like to ask anybody on the panel to offer their view on a broker's ability to divulge the information that is on the screen.

MR. FOX: I am sorry, I didn't hear the question, sir.

MR. SIMMONS: I would like anybody's view on the panel of the broker's ability to divulge the information on their screens. Can you do it? Is there certain information that you could legally divulge? Is there something else that is going on that might prevent you from divulging that information?

MR. FOX: I could say that the issue has not been determined. Obviously, it is one that has legal ramifications, and what we do know is Cantor Fitzgerald has been doing it, and I think there is a historical precedent that establishes that it may be viable to provide such information, but I don't think that can be determined at this juncture without either a legal determination or an understanding with the parties who are providing the information.

MR. McKAY: This does not precisely answer your question because it is a discussion at this moment as to the proprietary nature of that particular information. Perhaps we could compare this particular market to that of the equity market and the New York Stock Exchange. In effect, there the individual, the retail establishment, the institutional establishment places an order through a party, the party goes to the floor, the specialist, the trade is executed, and then that execution price is revealed on the ticker. That is last trade information. That is not the bid and asked price of the market.

In fact, the equity market, in comparison to our market, is the upstairs market, in which dealers operate between and among themselves in large blocks and then report the trades after the fact. You could draw that analogy to this particular market.

MR. ANDERSON: Mr. Swaim or Mr. Zacharias, do you have anything you want to put before us right now? Mr. Thieke?

MR. THIEKE: Most of you gentlemen, at least I think most of the gentlemen have within your firms some experience in brokering, providing these services in other markets, that is, other than U.S. Treasury securities, where some of the conventions are a bit different, where the concept of blind brokering is not as prevalent, where there is a practice of

name give-up. I wonder if you could share with us by virtue of analogies to the way the markets work in those areas what the differences are in terms of efficiency, liquidity and speed of execution where that practice of name give-up takes place, and how the burden of administering those limits is shared between the broker and the dealer that is trading. That is, is it the dealer's responsibility to know exposure versus an individual name, or does the broker undertake to monitor that in behalf of a dealer?

MR. FRANZESE: It depends on the day. When do you give up?

MKI trades corporates, municipals, repos, Ginnie Maes, zeros. The only area that we give up at time of execution is in the repo market, which is a slower market, and it's a financing instrument. It's not a trading vehicle, and we do not act as a principal in any way.

In the corporate or municipal market, we act as in-between in the settlement process. In the Ginnie Mae market -- and I believe all our firms work the same way -- we send the trade over to the Midwest, and six to seven business days, we drop, and the two principals are disclosed to each other. Everything done because of the length of time to settlement allows the give-up to take place several days after the trade, so there's not a position integrity question over who is behind either side of the trade. It's always after the fact.

Any of the other markets, if you look -- municipals, corporates, and Ginnies -- I do not believe trade anywhere near the size the Government market trades. If you combine them, you may hit $10 billion, $15 billion a day. So there's really nothing to compare against the Government market.

MR. ANDERSON: Does anybody else care to comment?

MR. GENO: I think we would have the same experience. We also broker corporate and municipal bonds on a blind basis, and our Repo department is the only one where there's a name give-up, and as Mr. Franzese mentioned, it's a much slower market, and it seems to me, if one envisioned transferring the Treasury market to that form, we couldn't possibly have the kind of market we have today.

And I think an example that I haven't worked that closely with, but the foreign exchange market, I think, is one that clearly, if you speak to people involved in that market and compare the differences between execution functions in the foreign exchange market where there is a name give-up and the Treasury market, there's just no comparison in terms of speed and efficiency.

MR. ANDERSON: Mr. Ketchum?

MR. KETCHUM: Mr. McKay, I'm a little confused by your equity analysis or analogy. As I understand the equity markets, not only is there a last sale, but there is obviously a quote disseminated from each of the exchanges. I also generally understand that while it is true there are upstairs-negotiated trades going on, it is the exception rather than the rule that that market is inside, given its size, the New York quote as opposed to outside, or at least at the same level. And also, of course, it has to be brought down to the exchange and we fit into that quote or provide an opportunity for other people to bid on it.

So it doesn't seem to be the same type of thing as the blind broker system. But that aside, if you put aside the question of legal restraints on your ability to disseminate the information, I would be interested in whether there is a view from any of the brokers that there is a detriment involved in allowing either the trade or the quotation information to be available publicly and what you think that detriment is, and whether it applies to both or just one.

MR. McKAY: I really don't know if there is. The history would tell us that there is not, if we compare the fact that one of our competitors does indeed do that and does a substantial amount of business, having made a business decision to disseminate the information and to deal with a customer base different than ours.

We have made a decision not to deal with a mixed customer base and to keep the information within that base. I really don't know exactly what would happen, frankly.

I mean, you could go through the theoreticals of what would happen. Anybody could do that.

MR. FRANZESE: You also have a second question, too. Let's say, RMJ said they wanted to go public. MKI and FNI said not. We would be up here again answering the same question, because the marketshare that RMJ and Cantor would have, someone can argue that their percentage does not truly reflect the market.

MR. KETCHUM: Well, maybe I can ask the flipside. Would any of you begin disseminating the information unless all of you did? Is it a view that that could hurt your business if one of you did it? Is it likely that any of you would make that decision on your own?

MR. HENO: I think it's possible someone might. Quite frankly, none have as yet, but I think it's certainly possible

So that I think one can't say yes or no to this question, that it really depends, in fact, on in what manner a change took place and what the extent of the change was.

MR. FRANZESE: In my opinion, and this is only my opinion -- we can argue this back and forth -- is that if we believe everything that we've heard here today, that we are seeing through the dealer at least a portion of that trade. What it seems like we're doing is expanding the market to additional participants with the same volume, which therefore would lower the transaction size and increase the cost to each of us, and that if we are getting at least one side of the transaction now, then I don't think we'll see the increased liquidity by expanding the market.

MR. MCKAY: Our firm has a slightly different perspective, and that is that we would like to increase our customer base, and we have conducted surveys and searches of firms that would meet the criteria that we'd like, which is credit, personnel that we know, and [illegible]. We have found that a good deal of those that wish to be a part of the market really do not intend to be dealer-makers. They are really customers who wish to come in and either buy or sell at a given point in time.

At least at this point in time, that is not the role that we, at this moment, choose to be. We choose to be a servicer to the dealer-makers in the ports that we do have.

[illegible] those who have indicated [illegible] which [illegible] wish to trade. The issue is to [illegible] and they will trade, we have found [illegible] want to trade. They either want to buy [illegible]

[illegible] -- and I [illegible] -- but do you [illegible] encourage transactions [illegible] directly between [illegible]

Basically, your comments seemed to be supportive, both as an association and individually with some caveats, and what I'm trying to take the measure of is the significance of those caveats. Using FBI's caveats of mandated trade submission, partial deliveries, participants' funds and monitoring, most of that, when I look at your caveats, sounds like what a good clearing agency should do. That's not controversial, but I'm trying to find out whether there's something more there. Is it controversial, trying to figure out what kind of participant fund for this market should be available, as opposed to any other market?

Is there more to this set of caveats than what looks like good management for a clearing operation?

MR. GENG: Well, it could be somewhat. The fact that this is a market which is dominated by blind brokers -- that is, a very large percentage of the volume goes through blind brokers, and in a normal clearing system, the tendency would be to apportion risk in relation to the volume of transactions. Obviously, that would be totally unacceptable from a broker's viewpoint, just to point out one factor that would be significant in our appraisal of any netting or clearing system.

MR. ANDERSON: Mr. Franzese?

MR. FRANZESE: In our case, we feel there's a liability issue in participant funds, because we perceive ourselves as agents. And, in fact, we've met with the Treasury, trying to give our position that we are an agent. We don't take possession. We trade only with regulated firms, and our participation into participants funds should not be on a full basis. We would net out in the netting system to zero. And the way the participants' fund is structured in the netting system, we would bear the brunt of any failures. And that's what we're arguing against.

MR. ANDERSON: Anything else? Mr. Zacharias?

MR. ZACHARIAS: I have just one question. Since no one has failed or none of your customers have failed or, in a sense, gone out of business, there really hasn't been a test yet to see what would happen to the system if a firm did, in fact, fail.

Would you explain for us what is the magnitude of the risk that you face if one of your customers were to suddenly go out of business, due to fraud or whatever, and what you would see as the consequences to the market, so we could get some assessment what you are really facing as a risk if one of them were to go out of business, if you were to make a mistake in putting somebody on?

MR. ANDERSON: Hot potato!

MR. McKAY: Fortunately, the instrument is a very liquid instrument, and the settlement cycle is very short. So you limit the risk, at least in that particular instance, insofar as if you happen to be in a situation in which you're stuck with a party which is going down, you can liquidate very quickly.

Or on the other side, you have really not paid for the transaction, so you can buy in quickly and deliver, and then work it out.

MR. FRANZESE: There is a role between agent and principal. A broker can use himself as an agent, and we confirm as an agent. I have heard all day, by some of the dealers and even some of the aspiring, there seems to be a little dispute as to whether we're an agent or a principal.

I believe we're an agent, and we would disclose both sides of the trades to the two principals and have them settle between themselves. Whether that would stand up, since we would probably be the only one left with money, whether we'd be sued, I think it would be tested in the courts. And I think that's one of the things we were trying to do with the NSCC with the netting system and with the Treasury -- define our position.

MR. GENG: I think as a practical matter, when one looks at the volume of trading in the market, it's fairly clear that if a failure were to occur in that system, it would pose problems well beyond the issues of principal and interest for the brokers. I think it would be a very serious problem of resolving for the entire financial system, for all of the dealers and brokers, and I would hope that that event will never occur, and I think that certainly stresses the importance of the credit integrity of the systems that we operate, because I don't think that the system, the financial system, the markets, can tolerate a failure of the kind of magnitude that could conceivably occur, given the volume that flows through these markets.

MR. McKAY: The issue of agent and principal is an ongoing one. But the majority, if not all, of the current customers share the view of the broker as that of an intermediary. In a given situation in which there were a problem, we are confident that the problem could be monetarily worked out.

A question which is interesting is that several of the persons who have voiced their opinion of expanding the market clearly view us simply as principal, and they wish to deal with us only as principal. That is a question which, frankly, as a broker, I would take exception to.

A new entry into the market who wants to come in and wants me to be purely a principal, or our firm, I don't think I would want to deal with that firm.

MR. SIMMONS: I have a follow-up to Mr. Zacharias' question. Mr. Geng, do you think that the Federal Reserve designation as primary dealer is important because of the monitoring, or to follow up on the statement you made, because of a perception in the market that the Federal Reserve would not let a primary dealer fail?

MR. GENG: I guess I would have to say both, to some extent. As a practical matter, I don't think there is any other system presently available in any market where the degree of monitoring that takes place is equal to that of the Federal Reserve. Clearly, for those dealers that provide their data daily to the Federal Reserve, there is an opportunity to truly evaluate the level of risk positions on an ongoing basis. I think that certainly is a matter that builds confidence among the participants in the marketplace. I think that is clearly why the use of the Federal Reserve's list has been the main criteria for participation in the market not only here but in many public bodies and throughout the country, who have established regulations for their investments, that designate a limitation based on the Federal Reserve's surveillance.

We mentioned perception because I think in some cases what we are stating is that we have a perception of what our customers' concerns are, but I think clearly they all rely on the monitoring aspects of primary dealership. I didn't mean to imply that there was a perception that the Federal Reserve would rescue a dealer who was going down. I think there is an ability through the monitoring process of the Federal Reserve hopefully to foresee and to constrain or advise dealers who were exceeding appropriate limits to hopefully prevent that event from occurring. It is obviously no guarantee. There could always be fraud or other events. I think you gain a much higher level of confidence given a daily monitoring system than obtaining a quarterly financial report.

MR. ANDERSON: Mr. Thieke?

MR. THIEKE: One is always interested from a public policy point of view as to whether changes, if changes were to take place in the structure of a given market, that were being promoted on the basis of public policy considerations, whether the results would in fact be consistent with what was intended. The people who are recommending change suggest that a change in practices with regard to access to the services you provide would broaden the depth and liquidity of the marketplace and they presume that either your firms would set reasonable standards in

terms of the creditworthiness of the customers that you do business with or some other acceptable mechanism would be found.

I am wondering what the possibilities are that the results might work in the opposite direction or the possibility that a firm would decide they only wished to do business with the very largest of participants, whose absolute dollar capital was very substantial, whose net liquid excess capital was substantially higher than what might be regarded as acceptable levels, and a result of which would be a market where it was actually more difficult rather than less difficult for a small firm to compete on an effective basis with the larger firms in the market.

Is there any possibility of that in an environment where there is a much broader base of access to the services offered by brokers, generally speaking?

MR. FRANZESE: I think no one knows for sure what would happen. That is one of the points we are trying to make. You have a market that works and works very well. By making changes to it arbitrarily, regulatory or any way, without significant tests, could hurt it or destroy it. That is our concern also.

MR. ANDERSON: Mr. Ketchum?

MR. KETCHUM: A number of times there has been a reference before to the importance of having a third party independent monitoring device for the brokers' brokers to depend on and to provide ongoing monitoring legitimacy for any party. Again, to return to that, if that is not a monitoring capability that the logical Government agencies feel is within either their mission or capabilities, if Government securities or if a netting system were developed and a clearing corporation was brought into the picture, would that corporation provide a feasible alternative as an ongoing monitoring capability controlled by its participants and directed by its participants to determine who participates and what type of monitoring would occur?

MR. GENG: I think the availability of such a system would certainly be a great aid in monitoring risk within the system overall. In fact, it would aid even the current system. Clearly, no broker or dealer individually knows what the overall exposure of his counterparties is, but a central clearing system obviously could monitor that.

Whether that central system, which presumably would be controlled by a board consisting of the owners, the participants in the business, whether that system would be relied upon by all participants as a substitute for or an alternative to the kind of credit confidence that we have obtained and market participants obtained from using the Fed, I'm not sure. I think it is possible that something along those lines, again, since it would

be some sort of a third party evaluation, might possibly be one method, but I'm really not as confident as I would be with some official designation or officially set guidelines with very close monitoring.

Obviously, this clearing agency wouldn't do the same things that the Federal Reserve does because they wouldn't obtain the same kinds of information. They would get supplementary information which I think would be beneficial, but it certainly wouldn't be as complete as to overall exposure.

MR. ANDERSON: We have run out of time, unfortunately. I would like to thank you, Mr. Fox, Mr. Franzese, Mr. McKay, Mr. Geng. Thank you very much. You have been quite helpful. We appreciate it.

Mr. Coats is Chairman of the Primary Dealer Committee, Public Securities Association. Mr. Ralph Peters is Chairman of the Board, Discount Corporation. This panel is labeled our primary dealers. Mr. Peters, we will start with you, sir.

STATEMENT OF RALPH E. PETERS, CHAIRMAN OF THE BOARD, DISCOUNT CORPORATION

MR. PETERS: You have the commeats that we have sent you under separate cover. Let me read my remarks today. I am Ralph E. Peters. I am Chairman of the Board of Discount Corporation in New York. I have been continuously associated with the business for some 32 years. Organized in 1918, Discount has long been recognized by the Federal Reserve Bank of New York as a primary dealer. As such, we are committed to bidding at each auction for United States Treasury securities, making a secondary market in them, and standing ready to transact with the New York Fed in its execution of domestic monetary policies. We also report our positions daily to the New York Fed.

Discount has submitted written comments to the General Accounting Office in connection with this study of secondary market trading in U.S. Government securities.

I would like now to highlight a few points and respond to some of the comments submitted by others to the GAO.

All of the commentators agree that blind brokering or, as we call it, anonymous trading, is an essential part of our efficient and highly liquid Government securities' market. Yet, those commentators who would expand access to such trading, not only fail to show concretely how they have been harmed by the present system, but equally important, failed to propose a workable solution. Indeed, their proposals could jeopardize the very system they praise.

As I will demonstrate shortly, the proposals put forward by advocates of expanded access would adversely affect the liquidity and efficiency of the Government securities' market and ultimately increase the costs of financing the Federal debt. These consequences perhaps should not be surprising, since the present structure of the Government securities' market is neither arbitrary nor accidental. Indeed, it is logically related to the very characteristics of that market and the functions of its participants and reflects decades of experience.

Unlike the corporate markets, where an issuer comes to the market at most, a few times a year, the U.S. Government offers new issues several times a week. If one includes the period of when issued trading, primary dealers are therefore always involved in distributing new issues. Corporate underwriters have the benefit of a distribution syndicate and price stabilization and are restricted in their use of the secondary market until the distribution is complete. By contrast, primary dealers must adjust their underwriting allotments unilaterally with no price stabilization and effectively have only the broker screens as a means of making these adjustments anonymously with others also engaged in the distribution.

For them, the brokers' screens are an essential part of their primary market underwriting function, as opposed to being a distinct secondary market.

Lazard Freres' assertion that limiting screen access to the primary dealers is analogous to restricting Stock Exchange trading to the initial underwriters of a corporation stock conveys a serious misunderstanding of the interrelationship between the primary and secondary Government securities' market.

As is discussed more fully in our comment letter, use of the broker screens is also essential to the other commitments undertaken by every primary dealer, to make markets in Government securities and to make bids and offers in secondary market transactions to the New York Fed as implementor of central bank money supply decisions.

In short, it is essential not only logical, that all primary dealers have access to the broker screens, since without them, the primary dealer could not do their job of underwriting the national debt.

What about expanded trading access to the broker screens? Credit standards, and a means of effectively monitoring compliance with them are absolutely critical to a system of blind brokering, whether the brokers act as agents or principals. Otherwise, participants if not first bankrupted, will lose at least their confidence in their system and cease to use it.

No commentator has come up with a means whereby compliance can be effectively monitored daily for a vastly expanded group of participants without significantly increasing costs, which must thereby increase the cost to the Government of funding its debt.

At present, the New York Fed monitors the primary dealers on a daily basis. The Fed has a keen business incentive to monitor ongoing creditworthiness, because unlike any other regulator, it actually engages in sizeable transactions with the entities it monitors, not only for itself but also for the account of many foreign central banks. If it does not monitor properly, not just other participants will lose money, the Fed itself will. That powerfully concentrates the mind.

Moreover, the New York Fed is in the market daily. It has a level of contact and knowledgeability with the market and its participants that is unequaled. If the Fed warns a primary dealer that its financial condition or trading practices cause concern, the primary dealer has a business as well as a regulatory incentive to respond quickly. Lazard claims, without offering any substantiation, that the Fed's business relationship with the primary dealers makes it "an unlikely watchdog of them." Lazard is 100 percent wrong.

The fact is that there have been no credit losses in anonymous trading by the primary dealers, a record that I do not think any other Federal regulator can approach.

Some may ask about granting screen access to aspiring primary dealers, some of whom report only monthly to the Fed. As I have shown, there are two reasons behind the present system of access to the screens. One is the credit consideration. The other is the important role the screens play in enabling primary dealers to carry out their responsibilities to the market. If aspiring primary dealers who have declared to the Fed their commitment to the Government market were not granted access to the screens, they could not adequately demonstrate to the Fed their ability to carry out these responsibilities. Therefore, it is necessary they be granted access.

We would, of course, be a great deal happier if the Fed would monitor all aspirants daily as it does the primary dealers and indeed it is so urged.

FBS Capital Markets Group suggests a clearing house arrangements, where the clearing house would monitor all credits and charge a fee to all participants to cover costs. As in any clearing house system, the participants collectively would bear the ultimate risk of failures and in some circumstances, each participant would bear the risk of its counterparties' failure. Either way, because the numbers in the Government securities'

market are so huge, participants would reasonably demand that credit compliance be monitored on a par with what the New York Fed now does.

For FBS to claim that "if credit standards were agreed upon, credit risk would be minimal," is naive.

The cost of setting up and staffing a clearing house to enable it to monitor daily reports from hundreds of participants would be considerable, even assuming that the clearing house staff could acquire the market expertise and business incentive to monitor all such participants as effectively as the New York Fed is monitoring the primary dealers. Transaction speed would be greatly reduced if all trades must be funneled through a single clearing house and all benefits and competition between various Government securities' brokers would be lost.

In short, much higher costs and less efficiency would result.

At present, trading in Government securities is very competitive, with an expanding group of dealers, primary and secondary, chasing potential investors. Spreads are generally acknowledged to be much smaller than in other markets and have narrowed even more in recent years.

I do not know where FBS Capital Markets Group ever got its example of a two thirty second spread on four year notes between the broker screen price and the price at which the primary dealer sold to a customer. I have not seen a profit margin like that in a long time. An investor stuck with such a mark up would soon learn about it from a competing primary dealer and probably would not do any more business with the first dealer. I would also note that FBS forgot about the broker's commission in calculating the dealer's hypothetical profit.

Moreover, it is misleading to suggest that primary dealers operate exclusively or even principally on a cost plus basis from the brokers' screen or that a profit can be determined on such a simplistic cost plus basis. Primary dealers are principals and market makers, each with its own inventory or short positions, its own cost basis in that inventory, which is acquired from customers as well as other dealers in the Fed or the Treasury, its own financing cost, its own view of where the market is going, its own competitive position and therefore, its own goal or needs as to increasing or decreasing its holding of securities of a particular maturity.

These are all important factors in the price a primary dealer quotes to a customer. For these reasons also, it is both erroneous and unfair to suggest, as FBS does, that the primary dealers trading when they have information from the broker

screen, is tantamount to trading on insider information. The primary dealers have no access to non-public information concerning the U.S. Government, the issuer of the securities, or economic data released by the U.S. Government or any other information that could be considered inside.

The bid and ask prices on the broker screens are, as I have shown, only one factor in the dealers determining what price he will bid or ask for securities. It would be quite an expansion of the concept of insider trader to make every securities buyer or seller in every secondary market disclose all the factors that went into the price he was bidding or asking for securities.

Lazard Freres would have us look to the corporate bond market. The corporate bond market is a small fraction of the size of the Government securities' market in terms of both average daily volume and the average size of each transaction. We understand that the corporate bond market is dominated by a few dealers who account for the majority of principal positions taken. The market is much less liquid and bid and offer spreads are much greater. Any anonymity of trading essentially comes from the fact that there are effectively only those few dealers whom a customer would call to buy or sell bonds and the other customers of those dealers are not known to the first customer.

In effect, what Lazard is urging is that the present Government securities brokers act as principals in much the way that these dominant bond dealers act in the corporate bond market. For five or six Government securities brokers to act as principal in that much larger Government securities market would require more capital support than the corporate bond dealers need, and vastly more capital than the Government brokers now have.

In addition, each broker would have to increase its staff considerably to enable it to develop adequate credit monitoring as well as expanded customer service capabilities.

This would increase the cost of the transactions and drive out brokers with insufficient capital, thus contracting the market and reducing liquidity, competition, and inevitably efficiency.

In short, the present system of primary dealer access to the broker screen is logical and practical, because they have the greatest need for such access and because expanded access beyond primary and aspiring primary dealers would significantly increase risk and cost to the system and therefore to the Federal Government.

Once again, I would emphasize that the primary dealers are not a closed club or oligopoly. Any entity can become a primary dealer -- that is, any entity can become a primary dealer -- if it meets the New York Fed's standards and is willing to make a public commitment to serve the Government securities market.

Oligopoly implies an exclusion of potential competitors. That is definitely not the case in the primary Government securities market or for primary dealership. Indeed, the number of primary dealers has expanded greatly in recent years to 40 from under 30 a decade ago. Numbers of 30 and 40 hardly constitute an oligopoly. Five new primary dealers have recently been recognized, and the number will undoubtedly continue to grow. At least a dozen aspirants are waiting in the wings and have been granted access to the screens.

Lazard's desired system already exists, quote: "All who meet the financial and other standards are permitted equal access to the screens in the trading of Government securities."

I would add a few comments concerning information access as opposed to trading access to the broker screens. First, we believe that most of our customers already have access to detailed price information throughout the day from a variety of sources. These sources include the primary dealers, the retail brokers, and Telerate, Quotron, and the Blumberg Market Master.

Second, dissemination of live bid and offer information could be seriously misleading, in that the prices quoted are for large-volume transactions. I might add that live bid and asked information is not reported publicly in the largest equity market, the New York Stock Exchange, either by specialists on the floor or by upstairs block traders. Last sale information would be less misleading if it included large and small dealer transactions. We would not object to having this information made more readily available, although we are not sure it is necessary and have not estimated the cost to the system for doing so, which I believe would be considerable.

In closing, there is just one other sort of an oral comment I'd like to make here. Because of my long association with this industry, I feel personally compelled to add a few closing remarks.

From the moment of my first introduction to this business, I was taught that making markets in the United States' debt, and hopefuliy profiting thereby, carried with it a certain responsibility to the Government and its taxpaying citizens, for as one phrases it, "The Treasury market is, after all, fraught with the public interest."

It is perfectly clear to me that Lazard Freres, a wealthy and, I gather, highly profitable investment banking firm, refuses, for whatever reasons of its own, to take up that responsibility, which some 52 other organizations have been perfectly willing to do.

Furthermore, it seems to me, they risk endangering the entire system to further their own selfish ends. We at Discount welcome competition, so I say, "Come on in, Lazard; the water's fine."

[See appendix IX for the written comments of Discount Corporation.]

MR. ANDERSON: Thank you, Mr. Peters. Mr. Coats?

STATEMENT OF MR. E. CRAIG COATS, JR., CHAIRMAN
PRIMARY DEALER COMMITTEE, PUBLIC SECURITIES
ASSOCIATION

MR. COATS: Mr. Chairman and members of the panel, I am pleased to appear before you today to discuss, in general, the current trading system for U.S. Government securities and, in particular, the issue of access to services provided by the interdealer screen brokers.

I am here on behalf of the Primary Dealers Committee of the Government and Federal Agency Securities Division of the Public Securities Association. The Public Securities Association is a national trade organization representing more than 300 banks, dealers, and brokers who underwrite, trade, and distribute U.S. Government and Federal agency securities, mortgage-backed securities, and municipal securities. PSA's membership includes all 40 primary dealers in U.S. Government securities as recognized by the Federal Reserve Bank of New York and all the nation's major dealers in mortgage-backed securities.

I am Chairman of the Primary Dealers Committee of the Government and Federal Agency Securities Division of PSA. I am also a managing director in the investment banking firm of Salomon Brothers, Inc. I have participated in the U.S. Government securities market for almost 18 years. I have substantial expertise in the secondary market for U.S. Government securities as both a trader and as a managing director of my firm.

My comments today will address with some specificity the issue of access to the services provided by interdealer screen brokers. Interdealer screen brokers permit fast, efficient, and highly competitive trades in U.S. Government securities between recognized market-makers, which include only primary dealers and firms recognized by the New York Fed as aspiring primary dealers.

Interdealer screen brokers provide each primary dealer and aspiring primary dealer with video display screens in the dealer's office. These screens show the bid and offer prices of each dealer who supplies its markets to the particular interdealer screen broker. A dealer can (1) submit its bid or offer via the direct telephone line to a broker; (2) show its market on a particular broker's screen; or (3) transact business by hitting a bid or taking an offering shown on the screen.

The broker system provides instantaneous markets to all primary dealers and aspiring primary dealers at the same time. This is a substantial improvement over the dealer-to-dealer telephone communications for trading that took place prior to the screens. In fact, the marketplace would not be able to effectively and efficiently handle the volume of today's business without the screens, absent substantially higher interest costs to the Treasury.

The primary question we are interested in today is whether access to these brokers' screens should be widened to include other than primary and aspiring primary dealers. It is the position of the Primary Dealers Committee of the Government and Federal Agency Securities Division of the Public Securities Association that such access should not be broadened to include other than primary or aspiring primary dealers.

The current system of trading Government securities is fast, efficient, and reliable. The system's structure has evolved over many years, and we would be taking a substantial and unwarranted risk if we tampered with it. To risk damaging the integrity of the system now would impair the ability of the markets to effectively handle the large volume of securities that Treasury currently issues and would more than likely result in higher interest costs for the U.S. Government debt.

The potential risks involved in altering broker access requirements are quite substantial. Brokers' screens are an integral part of a highly efficient and competitive Government securities market. Altering this mechanism could well have unintended and system-wide effects. Expanding access to brokers' screens could well reduce the depth, the breadth, and liquidity of the market and compromise the ability of primary dealers to perform their ongoing market-making functions so necessary for the efficient financing of this country's debt.

Interdealer brokers provide a specialized mechanism to enable primary dealers to carry out their responsibilities -- freely accepted in agreement with the New York Fed -- as market-makers in U.S. Government securities. On one side, primary dealers are required to bid on and purchase securities newly issued by the Treasury through the New York Fed. On the

other side, these same securities are sold by the primary dealers in the secondary markets to their customers and to other primary dealers.

The New York Fed requires the primary dealers to maintain a continuous market in these securities. As such, the secondary market cannot realistically be separated from the primary dealers' role as distributors of original issues. There is a continuous and integral relationship between the primary and secondary markets. Anonymous trading on brokers' screens is an essential element in preserving this relationship.

The practice of limiting access to the services of interdealer brokers originates with the brokers themselves. It is based on each broker's assessment of the business and credit risks. It reflects a judgment by each broker that restricting screen access to primary or aspiring primary dealers will provide that broker's customers with some assurance that the counterparty in a trade is financially responsible and capable of transacting business in the market.

Moreover, each primary dealer or aspiring primary dealer who is a customer of the interdealer brokers must make an independent determination about which interdealer broker or brokers will be provided with a particular bid and quote information which will be shown to the potential counterparties.

Brokers' screens provide the means of facilitating anonymous trading in the secondary market. Without anonymity, dealers, both primary and non-primary, would be able to determine current positions of other dealers in particular issues and would adjust their trading strategies accordingly. Given such a situation, dealers would not be able to bid in amounts and at prices that are reflected in the auctions and current market. If trading were not anonymous and the positions of particular dealers and particular issues were known, pricing against those dealers would be measurably affected and liquidity in the market would be reduced.

Anonymity in trading is therefore vital to the maintenance of a liquid, efficient, and secure market. Anonymous trading can only take place where the dealers who are trading are certain that their counterparties are responsible and that they have a long-term commitment to the entire market on a continuous basis in both good times and bad. Only by limiting broker screen access to primary and aspiring primary dealers can traders be assured of the creditworthiness and continuous market-making ability of their counterparty.

If brokers were forced to permit other than primary or aspiring primary dealers to have access to their screens,

dealers would be reluctant to use the screens for trading purposes. Without reasonable assurances concerning the integrity, responsibility, and market-making ability of a dealer's counterparty, anonymous trading would wither away, and liquidity in the marketplace would be dramatically and negatively affected.

The reason is simple. If non-primary and non-aspiring-primary dealers were permitted access to brokers' screens, users of the screens would have no assurance concerning the quality of their counterparties, and the utility of the screens would be measurably lessened.

The quality of one's counterparty in a trade cannot be effectively monitored on other than a daily basis. When-issued Government securities do not have to settle for two weeks following sale, during which time interest rate fluctuations are likely to occur, and trading losses may be suffered. The financial condition of a firm that is monitored on other than a daily basis could easily swing from a sound to an unsound financial position in a matter of days before other dealers become aware of the problem.

Because of its daily monitoring of reports and the knowledge that comes from participating in the market, the New York Fed can quickly learn of a dealer's problems and push for corrective action. If parties not monitored by the New York Fed were permitted to trade on the screens, the screens would be used less, and primary dealers and aspiring primary dealers would be forced to use less efficient, more costly, and much slower methods of trading. Again, the result would be higher interest costs for the Government in funding its debt.

The present system allows brokers instantaneously to display bids and offers and allows dealers to quickly and efficiently trade on this information. If the utility of the brokers' screens were compromised by legislatively eliminating current restrictions on access, the costs of both trading and funding the debt would, of necessity, increase.

Primary and aspiring primary dealers would use brokers' screen less. Trading efficiencies brought about by these screens would be lost. Price volatility would increase, and liquidity in the marketplace would be compromised. The end result of all of this would be that interest rates would be forced up.

Primary dealers have little incentive to use brokers' screens if the quality and reliability of trading counterparties cannot be assured. Primary dealers are not going to place their capital at risk in a market where they cannot be assured that their counterparty will be subject to the same rigorous requirements that they are subject to by the New York Fed.

It is important to understand that the brokers' screens are an integral part of a highly efficient and competitive Government securities market. As I have said, altering this mechanism could well have system-wide effects that could reduce the viability of the entire market.

There is simply no reason for this bleak scenario to occur. Primary dealer status is open to any party that meets the rigorous but necessary standards set by the New York Fed. A primary dealer must be actively engaged in the distribution of U.S. Government securities among investors, have adequate capital, make continuous markets, and have a long-term commitment to the market.

The New York Fed carefully monitors compliance with these criteria in order to assure the continued efficiency and reliability of the market.

The test of the system is best measured by the fact that there has never been a failure of a primary dealer. Also no other capital market has the ability to smoothly and efficiently handle transactions totalling billions of dollars a day with little price volatility and narrow spreads. The reasons for this success include limited screen access, blind brokering, and careful monitoring by the New York Fed.

Primary dealer status is central to the success of a smoothly functioning market for the sale of this nation's debt. The criteria I have just discussed for becoming a primary dealer are not so onerous as to prevent others from becoming primary dealers and assuming the responsibility that goes with that position. This is indicated by the fact that there are now 40 primary dealers, compared to 29 primary dealers ten years ago, 18 dealers twenty years ago, and 10 dealers thirty years ago. In fact, I understand that there may be a dozen additional dealers who are in the process of qualifying as primary dealers.

The Government securities market is intensely competitive at all levels. Spreads in the market are extremely narrow, given the sizes of the transactions involved. It is a highly efficient and liquid market. The fact that it is such a market is not fortuitous. Efficiency and liquidity in the market cannot be disassociated from the most important aspect of the market structure -- blind brokerage and restricted access to the brokers' screens.

Forcing changes in these two important features to the Government securities market may have unintended and detrimental effects. It is for these reasons that we believe the current system of anonymous trading and limited access should not be changed.

Thank you.

MR. ANDERSON: Thank you, Mr. Coats.

[See appendix X for the written statement by the Primary Dealer Committee of the Public Securities Association.]

MR. RAWLS: Excuse me. I hate to interrupt. I appear to be a gate crasher. My name is Waite Rawls. I am a managing director at Chemical Bank. I was under the impression that I was to testify today, but at your discretion I will either stay up here or defer to my colleagues.

MR. ANDERSON: I am sorry, sir. I thought you were accompanying Mr. Peters or I would have recognized you earlier.

MR. PETERS: He usually does.

MR. ANDERSON: Sir, fine. I would appreciate it if you could abbreviate your comments in some fashion, hold them to five minutes or so, please. We would love to hear what you have to say.

STATEMENT OF S. WAITE RAWLS, III
MANAGING DIRECTOR, CHEMICAL BANK

MR. RAWLS: I do not have extended introductory remarks. Chemical Bank sent their comments to Mr. Simmons in some depth.

I would like to highlight just one other area of concern. Many times there has been an analogy drawn between the government securities market and the foreign exchange markets. In the foreign exchange markets there is not closed access to the brokers, there is open access, and blind brokering is not done there. There is name give-up there. People have said that is a highly efficient market and highly effective. I would like to debunk this straw man a bit, if I could.

There are several major differences between the markets'practices. The foreign exchange market certainly trades very actively at very high volumes, but there is no need to issue securities and therefore no need to clear the market of large positions at certain times in the day.

As a matter of fact, when that is attempted, it is usually by central bank intervention, and the effect of that is to stop the market in its tracks and make it very inefficient. Therefore, if we were to deal without the blind aspects or the anonymous aspects, our feeling is that it would create that type of inefficiency in the market.

As a result, in the foreign exchange market you do not see big trades go through the market. One counterparty to another counterparty usually trade in the size of 5 million or 10 million at a time, never in multiples of hundreds of millions like you do see between primary dealers on an anonymous basis.

With name give-up, the market becomes dominated at times with who has got the position. We know that CitiBank or Chemical Bank or Bank of America has just bought or sold a lot, and the market stops functioning on an efficient basis as you try to corner the person who owns them or does not own them. We think that it would be a tremendous mistake to encourage that sort of activity in the government market. The anonymity of the blind brokering allows for big trades or big positions to be accumulated without knowledge of everybody else on the street.

As a final comment, foreign exchange is equally a credit intensive market where each party makes its own credit decisions. Some suggestion has been made that each of us dealers give up our independent credit decisions to some third party, either by a preset formula or some similar device. We do not think that would be in the best interest of Chemical Bank or consistent with safety and soundness in making credit decisions, so we would not like to see that at all.

Thank you.

[See appendix XI for the comments submitted by Chemical Bank.]

MR. ANDERSON: Fine. Let's make sure the reporter has your name again, sir.

MR. RAWLS: It is S. Waite Rawls, III, Managing Director, Chemical Bank.

MR. ANDERSON: Thank you, Mr. Rawls.

We will start with Mr. Simmons on the questioning.

MR. SIMMONS: Mr. Coats and Mr. Peters, both of your statements make much of the business relationship that the primary dealers have with the Federal Reserve. Both of your statements indicate that the business relationship with the Federal Reserve is extremely important in the daily monitoring process, yet it is my understanding that the Federal Reserve does not conduct business with all primary dealers on a day-to-day basis, and in fact, if they have a problem with the primary dealer, they will stop doing business with the primary dealer for a certain amount of time, but that primary will still have access to the interdealer broker system.

So I am not quite sure whether I accept the argument that the business relationship is that critical. After all, if the business relationship is that critical, then the only measure of creditworthiness is engaging in trading with the Federal Reserve and all that goes along with that. I wonder if you would comment on that observation?

MR. COATS: I am here as a representative of PSA. Would you like me to speak to you from PSA's point of view? I can't respond to that question from PSA because we haven't discussed that. If you want me to talk to you as a managing director from Salomon Brothers, that I could do.

MR. SIMMONS: Fine.

MR. COATS: Could you expand a little bit upon, Craig, if you would, the function or the trouble that it would cause the Fed to stop doing business with the primary dealer? What do you mean by problems?

MR. SIMMONS: It is my understanding that the Federal Reserve does not trade on a daily basis, does not engage in open market operations with the primary dealer community, with all primary dealers. There are certain dealers that it relies on more heavily. There are certain dealers that it relies on far less heavily. If, as Mr. Peters says, doing business with these people focuses the mind, perhaps the mind is more focused for a certain subset of the primary dealers than it is for other primaries, and yet the other primaries have access to the interdealer broker screen. I would like you to comment on that.

MR. COATS: My understanding is that as the Fed implements monetary policy, which it doesn't do every day -- for example, when it comes in to do repo or reverse repo -- it comes into the system and announces to all the primary dealers, to the best of my knowledge, that they are in doing repo or they are in doing reverses.

MR. PETERS: This afternoon they preannounced asking for bids on all Treasury bills.

MR. COATS: Every primary dealer, in my opinion, is aware of that, and then every primary dealer has the opportunity to show his collateral to the Fed.

MR. PETERS: In this case the obligation is to make the Fed a bid.

MR. SIMMONS: Isn't it true that the Federal Reserve does on occasion not do business with certain primaries because of problems that they are having with the primary? Perhaps their positions are too exposed or something like that.

MR. COATS: Mr. Simmons, not to my knowledge. To the best of my knowledge, the Fed would deal with all primary dealers the same. I think that would have to be answered by the Fed.

MR. ANDERSON: Mr. Thieke, it might be appropriate for you to speak up right now.

MR. THIEKE: It might be appropriate, but it might also be appropriate for us to cover that with you when we discuss our views on these things, not as a witness but as an agency participant.

MR. PETERS: I think there is one other thing that can be said about it. Each dealer does its own independent work as well on credit. It has to. We, for example, wrote a letter to the brokers and said that we didn't mind if they put wires into Drysdale but we did not wish our transactions crossed with Drysdale. So that was a case where we made that judgment in a particular case.

But it may be, and I don't know, that the Federal Reserve stops dealing with a particular dealer or something, but because they are monitoring the dealer, we feel confident that they are telling that dealer to cease and desist whatever it is they are doing and to unwind their positions before they go into a net deficit position and cause an accident. So the fact that they may or may not -- and as Craig has answered, I agree with him -- the fact is I have confidence that the Federal Reserve would have told that dealer that we are no longer dealing with you and we want you to unwind your positions, and that this is what you should do and cease in the broker's market, and let's get the house in order.

We have a great deal of confidence that that is what happens, and I think there has been evidence in the past that in fact that is what happens. As we said, there are no failures that have ever occurred in the primary dealer community, but that does not mean that there haven't been primary dealers that have gone out of business, because there have been.

MR. ANDERSON: Mr. Thieke?

MR. THIEKE: I would be interested in your views on how dealers as market makers utilize the services of the screen brokers and whether there are differences in the way a dealer approaches those brokers based on the customers that have access to the system. I have in mind specifically does a dealer tend to behave differently in terms of its willingness to make markets, in terms of the types of pictures it would show to a broker that has given broad access to a variety of participants in the market, including those that may not be market makers? Would it show a different willingness to quote bids or offers in a screen

offered by such a broker than it would on a screen offered by a broker whose customer base consisted exclusively of firms that had a commitment to market making?

I don't want to ask you to get into your firm's specific strategy, but just a general observation, if you can make one, about your understanding of dealer practices and not firm specific.

MR. COATS: The response from my point of view from running the trading desk in government securities at Salomon is simply that we put our pictures where we are going to get responses. There are no preconceived notions as to where we are going to put it or whatever. Quotes go into a system or a screen. Where there are other pictures there that may be a best offering on one screen versus everywhere else, then you put your bid in against where the best offering is because you would think that that person would have the best seller of that security. So the chances of doing business or having a transaction at that point should be improved greatly. I think this is true for no matter what securities you are dealing with. When you put a picture into a screen, you are doing it for a reason. You are trying to transact business, whether it be an off-the-run security, whether it be an on-the-run security. You are trying to promote volume and activity, and you go to where you are probably going to have the best success ratio, not regardless of who the screen is or what it does, but where the best pictures are.

MR. PETERS: Is that responsive to the question?

MR. THIEKE: I am also trying to get some sense as to whether a dealer as a market maker is more likely to react to pictures that are shown in a screen where there is a broader array of participants than they are to initiate, if you will, show pictures, which is more indicative of a market making function as opposed to simply reacting to something that is shown, which you might say is more analogous to simply being a trading participant.

MR. PETERS: I am a little hazy, in a way, about what you are really trying to drive at, Steve. Would we be more inclined to deal with the brokers that only dealt with other dealers as opposed to one that had all sorts of people?

MR. THIEKE: Ultimately, Ralph, I am trying to get an idea as to what extent would dealers' willingness and ability to make markets change as there is broader access to the services of the interdealer broker? There is one broker where there is broader access, and I am trying to get some sense as to whether dealers are as willing to make markets through that broker as they would be in other mechanisms.

MR. PETERS: There is one fundamental misunderstanding, and I think that maybe it is my fault. Dealers don't make markets to brokers. Dealers use brokers to effect changes in their positions, either because they suddenly read some news that comes over the tape and they want to go low in the market or short in the market, or reacting to what they see in the way of customer business going on or whatever.

So when we deal with a broker, it is voluntary on our part and we are using the broker to accomplish some purpose that we have to either buy or sell. When we deal with customers and customers ask us for a market -- and we too often, I should say, don't always know which way the customer wants to go -- if he wants the market, we make him a market. He can go either side. There the transaction is involuntary at that point. We might or might not really want to do the trade. I don't know if that is of any help to you.

MR. RAWLS: Steve, I would also observe that many times that a primary dealer comes into the market to either buy or sell securities, he has got a large size to do, whether that is 50 million or 100 million or something like that, and therefore, he is not looking necessarily for where is the best quote but where is the depth in the market because I need to get a lot done.

I don't know if you gentlemen have looked at the screens that we are discussing today, but frequently you see a bid for only one million bonds, but when somebody hits that bid, trade builds and a hundred ends up getting done. So therefore, you will choose your brokers by in many cases where the likelihood of building a trade like that is going to be the greatest.

Now, if non-primary dealers are on a screen, infrequently will you get that building characteristic in a trade, so if you really have a job to get done buying or selling securities, you usually shy away from those places simply because even if it is an attractive price, it is only good for one or good for two.

MR. PETERS: And they are likely to be scared away, too, by size.

MR. ANDERSON: We will move to Mr. Ketchum now. I would like all the panelists to have an opportunity to put a question to you.

MR. KETCHUM: I would like to explore a little bit PSA's concern that the public dissemination of brokers' brokers' quotation information as opposed to trade information might be misleading to your institutional customers. In other markets where inside quote information is displayed, of course, as in other markets everywhere, different institutions may pay

different markups. Indeed, some institutions may trade net, depending on the customer relationship with the dealer.

Notwithstanding those differences, institutions that I have talked to, at least, seem to like to know about the inside market and to be able to tell precisely what execution they are getting and precisely what markup they are paying. Why would a relatively sophisticated group of institutions that are involved in the government securities market not also like to have a little bit better feel of that, and why would they not be able to absorb that rather than be misled?

MR. COATS: Let me put my PSA hat back on here. I think from the standpoint of the over-the-counter market in governments, there is no commission. It is principal business.

MR. KETCHUM: That is why I said markup.

MR. COATS: The markup basically, if we bought securities a month ago, what is the markup? How does one determine today's price versus when the inventory was put into place? So I think there is a problem of looking at what one is costing. You go back and use your inventory cost or--

MR. KETCHUM: In the equity market you look at the existing wholesale price at the time, and one of the ways you determine that is by having access to the quotation information.

MR. COATS: Now, quotation information in the government securities market, I think when you look at these screens, whether you look at screens that deal with only primary dealers or screen that deal with people other than primary dealers, the markets are very, very narrow. We are talking about spreads where we are talking about 32nds, or half of a 32nd or 256ths. These quotes are readily available on the screen.

So for a sophisticated client to do business who is talking to any one of 40 primary dealers or aspiring dealers or anybody else, the knowledge of where the markets are is very, very intense. If, for example, a ten-year Treasury is trading 14 to the plus and somebody comes in and you sell them 10 million bonds at 16, you probably are never going to hear from that fellow again.

I think that the marketplace is very self-policing because of the number of people involved and the highly competitive nature of the quotes that go out.

MR. KETCHUM: If that knowledge is so intense now, how are they going to be misled by getting the additional information?

MR. PETERS: I can give you a couple examples. First of all, there is more than one broker and they are all competing with each other, so what takes place on one screen can often be going another way on another screen. In highly and rapidly moving markets, I have seen it where somebody will say the Long Bond is up at 30. I will be looking at the screen, and I will say they just hit at 28 bid for $10 million, what are you telling me that for.

I have seen that all the time. It goes back and forth. It isn't really last sale. I also think sometimes that a small transaction can take place, up at 30, and at the same time somebody is coming in as a discount corporation, and I have got 100 million to sell and he wants to know where I will offer them. I might sell them at 29 because that is where I want to sell them and I figure I want to move 100 and I can move 100 at 29, and if I tried to move 100, I might get five off at 30 but it would be down to 24 before I get the 100. See what I am saying?

MR. KETCHUM: If I can try to summarize that, I think what you are saying is that that increased information, which sometimes may not be reflective of the appropriate price for the size and nature of the transaction, at least causes you to have to do more explanation to your customer than you might otherwise.

MR. PETERS: I think there are many, many sophisticated customers where they don't really need to get that kind of information, and of course I think the trouble is the fellow who is buying odd lots or 100,000. There has to be a bit of a spread; otherwise, the dealer couldn't literally cover the cost of the clearance and the ticket and the counting of it and everything else. We tend to think of the government market that a round lot is $1 million. It is incredible how much goes through for so little money.

MR. COATS: You are talking about a market that trades $80 billion to $100 billion a day.

MR. PETERS: It really is mind boggling.

MR. ANDERSON: Mr. Bremner?

MR. BREMNER: If we could forget about recent technology and revert back to when the broker market was a telephone market, before the screens, and try to envision the growth in the dealer community and the growth and the increase in the number of primary dealers from then until now, which is hard to envision that taking place in that sort of environment, it does tend to lead me to a question. Is there a maximum number that can be effectively processed even using the technology of a screen?

I guess in relation to that, if there is a maximum, is it a numerical maximum or is it strictly a qualitative maximum? By qualitative, I mean both the market making and credit quality.

MR. COATS: I think when you talk about how the growth of the market has taken place, if you look back in the late sixties, I don't remember what the size of the Treasury market was then but we had roughly 14, probably, primary dealers at that time. I think the answer to your question is such that the market has responded, the number of primary dealers has responded to the growth in the Treasury bond market, and I think the number of primary dealers is going to continue to expand as the world financial markets become closer together.

We have primary dealers now who are representing foreign institutions, and I think that is going to increase as we go forward in time and the financial world shrinks, and the financial markets are going to continue to expand.

MR. PETERS: I think of the sheer number of different issues involved that the Treasury has outstanding now, forgetting the volume that is there. When I came in I can't really remember how many there were, but I think there was a point in time when I was trading that I could give you a read off the price and make a market for a million up in just about every single issue the Treasury had on the coupon list.

I used to give out runs one to five, and I could switch over and probably give out a run, which is the way we used to trade between dealers. We always agreed to make markets with each other, and actually that is still true today. We don't do it because it's impractical, but we can. The fact of the matter is I could probably make a market all the way down all those old TAP issues that came out in the war and everything else.

Now there are 245 different coupon issues alone in the Treasury market. You can imagine if we didn't have the electronics what kind of a mess we would be in.

MR. COATS: Plus the volumes. It used to be that you would be talking on the phone to the broker and you would trade half a million or a million bonds, and today when you are transacting business, the flow of inquiry that is coming in from your client, more often than not you will say to the broker to hit the bid and make it 100, and you get off the phone and do something else because the time demands are that intense. Then you are watching on the screen as the trade builds up.

MR. PETERS: It is also true that a lot of the volume and a lot of the activity in pricing occurs in the so-called active issues. There are a lot of issues on the Treasury list that, in

fact, don't always trade, and dealers have to make a market in them because there is nothing going on in the broker screen and they make a market there in what they think is an appropriate relationship to where maybe something else is actively trading because it is all the same credit.

MR. ANDERSON: We are going to run over five minutes and cut down on the time that we are going to use for wrap-up, which was to run from 4:45 to 5:00.

Mr. Becker?

MR. BECKER: In view of the time, let me try and state this quickly. I think I understood Mr. Peters' argument that you needed an ongoing business relationship with money and risks to be confident of the creditworthiness monitoring that is provided through the New York Fed. What I didn't understand was the PSA's argument that the primary dealer status, with its concomitant distribution network and long-term commitment, is necessary to your comfort with that creditworthiness determination. I don't understand what, if any, relationship that bears to your assurance that someone is going to execute a trade.

MR. COATS: PSA, basically, if you understand his argument you understand the PSA's representation of the feeling of the community, and I think that it is all really tied in together. I don't know how you can separate any of these thought processes out.

MR. PETERS: I think a long-term commitment implies that the company has put its capital back of this endeavor, that it is a market maker, that it has a competent trading desk of marketing professionals that have been with the company for some period of time and are making a career of it and have the intention to remain with the company, and that the company has a research staff, that it has a good bookkeeping staff, that it is geared up and knows risk, that it has experienced risk. It is professional. To be that kind of a company requires more than just deciding let's take a shot at this for a couple of months, fellows, and if we don't like it, then we will get out.

In other words, I think it is a feeling of competency that you derive when somebody says I want to go into this business and I'm willing to commit the firm to it and I'm going to staff up adequately.

MR. RAWLS: It is clearly more than a question of capital. Even the Federal Reserve in their standings or the way they look at prospective primary dealers, you have to have much more than capital for a while before they will even let you apply, and then they watch you for a year. What they are trying to determine is that track record, that character, that long-standing commitment,

not simply the fact that you have got $25 million that you will stake today, because you may be gone tomorrow.

MR. BECKER: I am just saying I can understand why the Fed would be interested in that before it established that business relationship. I was trying to figure out how that related to your assurance that the party will perform the trade.

MR. PETERS: I think we feel more comfortable when we are dealing with somebody whom we feel has a long-term commitment and isn't trying to make a fast buck, we will say, without any really competent staff to recognize risk when they see it.

MR. BECKER: The New York Fed has an interest in distribution. But for your creditworthiness purposes, the distribution network doesn't seem terribly important.

MR. RAWLS: It is not terribly important. As competitors, we would just as soon nobody else had a distribution network, but the other things are very important. Ralph and Craig may disagree with me on that.

MR. ANDERSON: We have one last question, now, from Mr. Zacharias.

MR. ZACHARIAS: One thing we have been trying to do in the course of this study is to try to put our finger on exactly how good the Cantor Fitzgerald quotes are relative to the quotes shown on the interdealer broker screens. Early on we realized that we couldn't make a judgment because of the nature of the trade building process. You really can't just look at the spread on one versus the spread on another at the same time and make a judgment. Much to what you were saying about the building of the trades.

Is there a difference in the kind of trades you conduct and your ability to build a trade on the retail screen versus the interdealer screen? Is there a consistent difference? Some people have argued that those who have access to the retail screen have pretty much as good a feel of the market or should have a pretty good read on the market. I would just like you to maybe elaborate a little bit more on how you use the retail screen and its quality.

MR. RAWLS: Any one broker can give you an incomplete picture of the market. The best bid in the market can be seen on any one of the seven screens at any given time. Some of the brokers clearly have more depth because they do more volumes than other brokers. Cantor's volume is not nearly as great as the volume of FBI or RMJ, for instance. So therefore, typically you would not build as many trades, you would not see as many large trades on Cantor just like the other smaller but exclusive,

if you will, brokers. So there are a whole lot of things that go into it.

MR. COATS: But yet the quotations you will see, the pictures you see are very, very tight pictures. They are not eighth of a point spreads or two 32nd spreads. Most of the time they are a plus or 128th.

MR. ZACHARIAS: Just to follow up on something Mr. Peters said. He mentioned the fact that you may see on one screen a heavy buy going one way and see the exact opposite activity on another screen. If I was only limited to seeing the Cantor screen, could I be seeing a false picture of the market? I am seeing the buy business on one side and I don't have the view of the other screen so I don't know what is going off on the other side, and I might get a false reading? Is that a logical argument taking what you said thus far?

MR. PETERS: I suppose you could say it can happen, but it would be pretty quickly corrected, probably, out there in about two seconds flat because if there was a high bid on the Cantor screen and suddenly somebody got taken up on one broker here and got whacked with the next one, somebody would say, hey, hit that 32 bid on the Cantor screen.

MR. COATS: For example, today one of the largest pictures shown was on the Cantor screen today, about ten minutes before the auction today, when 100 million bonds were offered. Now, if somebody was trying to make a false picture by showing that offering low, for example, so they could do something -- you know, whatever they were trying to accomplish -- somebody could turn around and say, hey, 100 million bonds, I bought it, and what happens. That would have been a very large trade, and it is a retail access screen. So I don't think you can draw any conclusions or thought processes into that kind of thing.

The market is so efficient that once you put a picture into the broker, it is good for 30 seconds or a minute. That picture can't be touched. You can't call them up and put 100 in and take it out right away or, say, pull it out if somebody comes in to buy it. You can't do that.

MR. ZACHARIAS: What you are saying is the ability of the other primaries who also could access Cantor Fitzgerald would eliminate any effect that --

MR. COATS: Right. I think it would eliminate and smooth out and make the market highly competitive and efficient.

MR. PETERS: There is one thing. I can't remember who asked the question, but it was when the brokers were up. You were talking about, I think, the feasibility of somebody saying we

won't deal with that guy, and then what would happen. Well, there obviously is a great deal of time delay and all the rest of it. But one other thing, and I didn't hear them answer but I believe it is true, and that is what happens, of course, is that immediately there is a trade, you see, and it is flashed on the screen that 100 million traded up at 30, at which point, after some time lag, it is discovered that that is a bum trade because it was a transaction between two people who had not agreed to be willing to transact.

Now in the meantime the rest of the market takes its cue from that and starts trading up on the strength of the fact that 100 million traded up, and now the next thing that comes over is we have got to say "Error, no trade." So that is another penalty, and after a while that gets very destabilizing.

MR. ANDERSON: That was not the last question, by the way. I have another one here that Mr. Ketchum would like to put to you.

MR. KETCHUM: Mr. Coats, if I can ask you to shift hats again for a second, your firm obviously, along with being a major player throughout the government securities market, is a major player in certain -- I don't know whether discreet parts is appropriate, but to give examples, the mortgage-backed area, the zero coupon area. In any of those discreet pieces of the government securities business, do you find yourself dealing more or less with non-primary dealers than in your basic government securities business?

MR. COATS: Fortunately for me, the firm is a very, very complicated place, the departments are very, very large and my responsibilities are only government trading. The mortgage-backed area is handled by four other managing directors or five other managing directors, so I really couldn't speak as to how they transact their particular business.

MR. KETCHUM: Just a follow-up on what Mr. Peters indicated before about the concern of any individual firm indicating they would not trade with a particular person through a brokers' broker system. Assuming that at least some of the primary dealers, and I assume one or more of your firms probably deal with some non-primary dealers on a direct basis, were there to develop a netting system, a clearing corporation capability similar to what you have for mortgage-backed now and what is at least on the discussion table now, would you feel differently if that third party which you controlled as participants engaged in monitoring with respect to combining that monitoring and credit requirements by the brokers' brokers? Would you feel differently about expanding the persons with access to the screen?

MR. PETERS: Not really, no. I mean I wouldn't have the confidence that they could have the capability of monitoring that many people that would be involved.

MR. COATS: Your use of the word "control," I think, is misleading.

MR. PETERS: I have no control.

MR. COATS: You can't control a third party or somebody else even though you may have an excellent relationship with them. I am sure that that was true with people at ESM or Bevill Bresler or Drysdale. They had excellent relationships with somebody in the marketplace to be able to accomplish the liquidity and the volumes of business that they were transacting.

MR. PETERS: We deal with lots of secondary dealers and enjoy their business, but we take each one on its own.

MR. COATS: Each major firm has its own credit committee that reviews all these.

MR. ANDERSON: Mr. Rawls, Mr. Peters and Mr. Coats, I would like to thank you very much for your contribution here today.

Before we break, I would like to repeat some things that I said early on. First, I mentioned that a written transcript of the hearings will be prepared and available for review in the Law Library at the GAO Building at 441 G Street, as well as GAO's New York Regional Office in about two weeks. I also noted that GAO will keep the public comment record open until 5:00 p.m. February 11, a week from today, so that market participants can respond to any issues raised in the written submission or during testimony today.

I would like to express our collective thanks to the witnesses today. I thought they made an outstanding contribution and created a tremendous record that will be of great value, I think, in helping sort these issues out. I would like to thank our panelists, as well.

On that note, thank you all very much.

[Whereupon, at 5:00 p.m. the hearing was concluded.]

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FEDERAL REGISTER, JANUARY 2, 1987, PART IV. GENERAL ACCOUNTING OFFICE NOTICE OF PUBLIC HEARING, REQUEST FOR COMMENTS ON THE NATURE OF THE SECONDARY MARKET FOR U.S. GOVERNMENT SECURITIES

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federal register

Friday
January 2, 1987

Part IV

General Accounting Office

Notice of Public Hearing and Request for Comments on the Nature of the Current Trading System in the Secondary Market for U.S. Government Securities

GENERAL ACCOUNTING OFFICE

Notice of Public Hearing and Request for Comments on the Nature of the Current Trading System in the Secondary Market for U.S. Government Securities

AGENCY: General Accounting Office (GAO)

ACTION: Notice of public hearing and request for comments

SUMMARY: The General Accounting Office (GAO) is seeking comments on the nature of the current trading system in the secondary market for U.S. government securities. This request is part of a GAO study, mandated in the Government Securities Act of 1986 (Pub. L. 99-571) (Act), that is to include an assessment of whether quotations for government securities and the services of government securities brokers are available on terms that are consistent with the public interest, the protection of investors, and the purposes of the Act. As provided by the Act, the study is being conducted in coordination and consultation with the Board of Governors of the Federal Reserve System, the Treasury Department and the Securities and Exchange Commission. Comments received in writing will be shared with those agencies.

The Act also specifies that GAO and these agencies conduct at least one joint public hearing during the course of the study. Representatives of the government securities market will have an opportunity to discuss their views on the topics covered in more detail in the supplementary information included in this release. The results of that hearing will be merged with the individual responses to this request for comment to form a body of evidence for consideration in GAO's report which is due by April 28, 1987 (6 months after the date of enactment of the Act.)

DATES: Comments must be received by January 23, 1987. The public hearing will be held on February 4, 1987, at 10:00 a.m. (e.s.t.) at the Public Meeting Room (Room IC-30) of the Securities and Exchange Commission in Washington, DC, 450 5th Street NW. Individuals or organizations wishing to present their views at the public hearing should contact the GAO officials listed below by January 16, 1987.

ADDRESS: Please file five copies of your comments with Craig A. Simmons, Senior Associate Director, General Government Division, U.S. General Accounting Office, Room 3862, 441 G Street, NW., Washington, DC 20548. Refer to File No. 233175.

All comments will be available for review Monday-Friday, 8:00 a.m. to 4:45 p.m. (e.s.t.), in Washington, DC at GAO's Law Library, Room 7056 and in New York, at GAO's Regional Office, Room 4112, 26 Federal Plaza.

FOR FURTHER INFORMATION CONTACT: Stephen C. Swaim or Paul Zacharias, (202) 452-2133, General Government Division, U.S. General Accounting Office, Federal Reserve Audit Site, Federal Reserve Board Building, Room B-2227, Washington, DC 20551.

SUPPLEMENTARY INFORMATION: This supplementary information section explains the objective, scope, and methodology for the GAO study in light of the legislative mandate and discusses the topics and questions respondent should address. The discussion assumes a basic familiarity with the government securities market and the role of specialized government securities brokers. Additional information about the nature of the government securities market can be found in the references shown in Appendix I, especially GAO's report entitled: "U.S. Treasury Securities: The Market's Structure, Risks, and Regulation" (GAO/GGD-86-80BR, August 20, 1986).

Background

The secondary market for government securities involves trading in Treasury issues (bills, notes, bonds, and zero coupon instruments derived from Treasury securities), various government-guaranteed and government-sponsored enterprise issues, and mortgage-backed securities. The when-issued market and the market for repurchased agreements also involves trading activities similar to those in the secondary market. Each day, hundreds of billions of dollars of government securities are bought and sold in a world-wide, decentralized over-the-counter market, with clearing and settlement typically occurring on the next U.S. business day through U.S. depository institutions located primarily in New York City.

The market's depth and liquidity results in large measure from the activities of marketmaking dealers that compete with each other and stand ready to buy and sell securities for their own account. Investors seeking to buy or sell securities can contact one or more of a large number of dealers who will provide a price at which investors can immediately execute their transactions. While any dealer can act as a marketmaker for certain securities or maturity ranges, 40 primary dealers designated by the Federal Reserve Bank of New York (FRBNY) are expected to serve as marketmakers in a broad range of securities and maturities. In addition, a number of dealers who have made known their desires to become primary dealers, are attempting to demonstrate their marketmaking capability and other qualifications to the FRBNY. As part of these other qualifications, dealers are also expected to be creditworthy and participate actively in Treasury auctions, demonstrate a long-term commitment to the market, and file daily reports on net positions with FRBNY. The number of primary dealers has grown over the years.

Screen Brokers

The activities of specialized brokers, known as screen brokers, are a central feature of the wholesale secondary market trading system for government securities. Of the over $80 billion in average daily transactions reported by primary dealers to FRBNY, about half is effected through screen brokers. Screen brokers provide their customers with fast execution of a high volume of trades. They allow their customers to trade relative large quantities on a blind basis—that is, without revealing their identity. Blind trading is a feature felt by many to contribute greatly to the depth and liquidity of the government securities market.

Screen brokers are for-profit, private firms that operate the equivalent of their own trading system for their customers. Employees (known individually as brokers) of the screen broker firm service the account of particular customers for certain types of securities or certain segments of the maturity spectrum. Generally, an individual broker will handle from one to four accounts depending on the level of business, as the brokering process in an active market can involve almost continuous telephone contact with a customer's trading desk.

All brokers serving the same type of security or maturity category sit so that they can see and talk to each other while at the same time following the activity on the screen in front of them. The brokers insert quotations on the screens reflecting their customers willingness to trade a specified quantity at the quoted price. Only the best bid and ask quotation is shown for an issue, and it is usually posted for a small quantity ($1-10 million). When a bid is "hit" or an offer price is "taken," the screens display the results of the interaction of these brokers as each attempts to satisfy his/her customer's orders.

Currently, seven screen brokers, known as interdealer brokers, restrict

access to their services to a customer base drawn from the 40 primary dealers and other dealers who have stated they aspire to become primary dealers.[1] Though not all exactly the same, there is a considerable amount of overlap in the customer lists of the 7 interdealer brokers. The number of customers handled by interdealer brokers ranges from 35 to 53. Interdealer brokers, who claim an agent relationship with their customers, do not make information on their screens available to parties without access.

The industry practice linking primary dealer status and access to screen brokers has existed since the advent of screen brokering about a decade ago. An increase in the number of aspiring primary dealers with access has corresponded with growth in the number of aspiring primary dealers during 1985 and 1986. Currently, some aspiring dealers with access to one or more of the interdealer broker screens are reporting daily to FRBNY while others are reporting monthly.

Two others screen brokers, often referred to as retail brokers, have established trading systems that include not only primary and aspiring primary dealers, but also other dealers and major nondealer institutional investors as well. Retail brokers actively monitor the credit standing and set limits on the trading activity of these other dealer and investor customers because they execute transactions as principal and must perform should a customer fail. Both retail brokers told GAO they service about 200 customers including the majority of primary and aspiring primary dealers. While retail brokers provide a means for interdealer trading, their business focus is to provide a means for major retail customers to trade with the major dealers and each other. Retail brokers sell the right to view and disseminate the information on their screens to commercial financial quotation systems.

Objective, Scope, and Methodology of GAO Study

In passing the Government Securities Act, the Congress recognized the government securities market as the largest, safest, most efficient, stable and liquid securities market in the world. The Congress also expressed its intent that any regulation not impair the efficient operation of the market, increase the costs of financing the Federal debt, or compromise the execution of monetary policy. To that end, the Congress directed the legislation at identified weaknesses in the market while preserving, to the extent possible, existing relationships. It specified that nothing in the Act was to limit or impair the Federal Reserve Bank of New York's business relationship with primary dealers and those seeking to become primary dealers.

The Congress also sought to understand the complaints of certain dealers who do not have access to interdealer screen broker systems. Those dealers alleged that such limited access systems are inequitable, unnecessarily restrictive, and in conflict with the public policy goal of ensuring the maintenance of a fair market for government securities. These dealers have asserted that the scope of coverage of retail brokers is not adequate to meet their needs and that they need access to the interdealer screens in order to compete fairly in the marketplace. Such arguments were countered by primary dealers who asserted the benefits of the existing arrangements, particularly in light of the primary dealer's significant participation in Treasury auctions and their secondary market activities in a broad range of government maturities.[2]

In recognition of the complexity of the access issue, the Congress included a provision in the Act for GAO to study the issue so that Congress can have sufficient information for it to evaluate the allegations. Section 104 of the Act directs GAO to study the system of trading in the secondary market for government securities. The study is to evaluate the extent and form of availability of price information and brokers services, and whether these aspects of the market are available on terms which are consistent with the public interest, the protection of investors, and the purposes of this title (the Government Securities Act of 1986), which include the maintenance of fair, honest, and liquid markets in such securities.

The principal task of GAO's study is to assess the public policy considerations related to access practices. In addressing this topic, the study will be concerned with both access to the brokers' systems for trading purposes and access to information contained on brokers' screens by government securities dealers or other investors that do not have trading access.

GAO recognizes that in the time allotted for this study it may not be possible to answer all relevant questions. Complicating deliberations on this issue is the fact that regulations required by the Act are being implemented and changes to the clearing, settlement, and funds transfer arrangements that could affect risks in the blind brokering system are also being considered by industry officials and the Federal Reserve System. Nevertheless, we intend to try to reach judgments about the general direction that public policy should follow in seeking as fair and efficient a secondary market as possible, consistent with the control of risks and the ability of the Treasury and Federal Reserve to carry out their debt management and monetary policy functions.

Topics On Which GAO Is Seeking Comment

GAO is soliciting information to identify problems, if any, possible alternative arrangements that might be more desirable, and the consequences—good or bad—that would accompany particular changes in the current system for quotations and broker services. To guide comments, we have grouped questions around three topics: Trading access to broker systems; access to quotation information; and the utility of brokering services and quotation practices in the secondary market.

Because GAO will not attempt to conduct its own quantitative economic studies on the structure of the market or on market trading practices, those commenting are urged to be specific, citing wherever possible, quantitative information in support of their positions. Respondents are also encouraged to bring to GAO's attention any matter pertinent to the inquiry that does not fall within the structure presented below.

Trading Access

GAO has been told by market participants that restrictions on trading access represent screen brokers' business judgments based on such considerations as:

—The desire of their customers to only trade on a blind basis, which necessarily means that they must be assured that customers are creditworthy;

—The broker's need to control risks by dealing only with creditworthy firms with the operational capability to process transactions on time and avoid fails;

[1] Aspiring dealer status is based on the dealer's assertion that it is recognized as such by the FRBNY. The FRBNY will not confirm or deny whether a dealer is an aspiring primary dealer or state whether the firm is submitting daily or monthly reports.

[2] The Department of Justice is conducting an investigation of anti-trust concerns regarding the operations of government securities brokers. GAO's study will not attempt to reach conclusions about the Federal anti-trust implications of how the market is presently organized.

—The need to have customers that all other customers will accept as creditworthy, because letting individual customers restrict their quotations would have an unacceptable negative effect on the speed of trading;
—The oversight and monitoring provided to primary and aspiring primary dealers by the Federal Reserve;
—The desire to maintain a certain level of service quality which is constrained by the present configuration of employees and equipment used by the brokers; and,
—The brokers' desire to deal only with customers who have a volume of business sufficient to pay for services provided.

The relative importance of each of these factors is unclear.

Questions

1. How important is blind brokering for the efficiency and liquidity of the government securities market?

2. What are the costs and benefits of the current system of limited access blind brokering? What alternative arrangements, if any, should be considered? How do their costs and benefits compare with those of the existing system?

3. Of the considerations influencing screen broker decisions on which firms should have access, which do you feel are relied on most heavily and which least heavily? Is this appropriate? Please explain.

4. What are the consequences of current access practices for the liquidity and efficiency of the market and for various market participants? In your answer, please distinguish carefully between types of dealers and investors.

5. What risks are associated with blind brokering? Who bears these risks? Do the risks necessarily increase when the number of dealers trading on the system increases? What alternatives exist to control these risks? Which, if any, of these alternatives provides an acceptable level of risk control at a reasonable cost?

6. For what reasons do you consider it acceptable or unacceptable for brokers to require new customers to first have a business relationship with the FRBNY as a primary dealer or to be an aspiring primary dealer before it will consider the customer's application for access? To what extent, if any, does your answer depend on your perceptions of the FRBNY's business relationship with primary dealers? If it does, what aspects of that relationship are most important?

7. What would be the consequences if the list of dealers with trading access to interdealer screen brokers were to diverge significantly from the list of primary or aspiring primary dealers? Would brokers allowing expanded access lose business? If they did, would the loss of major market participants from the screen brokering system make it harder to sell the public debt or to conduct monetary policy? Would risks in the interdealer market increase significantly? To what extent might any cost of allowing such access be offset by any benefits from greater participation by other dealers in these systems?

8. Under what conditions, if any, should firms who are neither primary nor aspiring primary dealers but who specialize in certain segments of the Treasury, agency, or mortgage-backed securities markets, be able to obtain trading access to the interdealer broker screens for segments of the market in which they specialize? Would greater availability of limited access arrangements for such dealers affect the overall depth and liquidity of these markets? Please explain.

9. The Treasury Department must adopt rules for brokers and dealers, including rules for financial responsibility. Would you expect these rules, and the associated enforcement of them by the appropriate federal regulator, to affect access to interdealer broker trading systems? In answering these questions, what assumptions have you made about whether interdealer brokers are acting as agent or principal?

10. Would development of a netting system for clearing and settling government security trades affect the risks faced by screen brokers and their customers? How, if at all, would you expect such developments to affect access to interdealer broker trading systems?

11. How might actions designed to reduce daylight overdraft exposure now being considered by the Federal Reserve System, affect your assessment of the blind brokering system and access to it?

Access to Quotation Information

Public availability of current price and last sale information is an important element of U.S. securities and commodities laws as they relate to publicly traded equity securities and options and futures contracts. The wide dissemination of such information is regarded as important for investor protection in these markets because it gives investors a reliable, independent source of information with which to formulate investment strategies. Such dissemination may also facilitate price competition.

However, like many other over-the-counter markets such as that in corporate bonds, no such requirements exist in the government securities market. As noted above, interdealer brokers do not make information available to those without trading access. However, subscribers to certain financial reporting services can see the information that is available on retail broker screens.

Questions

1. What types of customers, if any, who cannot trade on interdealer screens should have access to such information? In your answer, please be specific concerning the type of customer and consequences for the market.

2. What would be the benefits and costs of making information from interdealer brokers available to parties without trading access? Would interdealer brokers have the legal right to sell or divulge such information? If so, how should the dissemination costs be paid?

3. Would public dissemination of the information displayed on interdealer broker screens overcome a substantial portion of the concerns about limited trading access? Please explain.

4. Do dealers who are able to view the interdealer screens have an advantage in other markets, such as futures or options exchanges, over participants in these markets who are limited to seeing the retail screens? If such an advantage exists, how is it manifested, how significant is it, and should it continue or be eliminated? Please explain.

5. Is the information on market prices currently collected and published by the Federal Reserve useful? Please explain.

Utility of Brokering Services and Quotation Practices

The previous sections have directed comment toward specific issues associated with access to interdealer broker systems for trading and information purposes. Much of that discussion focused on access issues affecting major market participants. However, for other types of investors, there is a more general question regarding the availability of quotations and whether best execution is obtained through the existing secondary market trading mechanisms.

Questions

1. In the government securities market, how do investors evaluate the terms and conditions on which their trades were executed?

2. Discuss any aspects of broker or dealer practices, not previously mentioned, that might be viewed as inconsistent with the principles of

investor protection and the maintenance of fair, honest, and efficient markets? What, if anything, should be done about these practices? What are the costs and benefits of any such actions?

3. Please describe any characteristics and practices of other markets that are appropriate benchmarks for evaluating the reasonableness of broker service and quotation availability in the government securities market.

Appendix I—References

Hearings

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U.S. General Accounting Office, U.S. Government Securities: Questions About the Federal Reserve's Securities Transfer System (GAO/GGD–87–15BR, October 20, 1986)

U.S. General Accounting Office, Securities Regulation: Securities and Exchange Commission Oversight of Self Regulation (GAO/GGD–86–83, September 30, 1986)

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James L. Howard,

Deputy Director, General Government Division.

[FR Doc. 86–29456 Filed 12–31–86; 8:45 am]

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APPENDIX II

COMMENTS SUBMITTED BY LAZARD FRERES AND COMPANY

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COMMENTS AND RESPONSES
OF
LAZARD FRERES & CO.

SUBMITTED TO THE
GENERAL ACCOUNTING OFFICE

Regarding

Notice of Public Hearing
and
Request for Comments
on the
Nature of the Current Trading System
in the
Secondary Market for U.S. Government Securities

"Federal Register," Vol. 52, No. 1
Friday, January 2, 1987

Lazard Freres & Co.
January 23, 1987

Patton, Boggs & Blow
Counsel for Lazard Freres & Co.

Comments and Responses

of

Lazard Freres & Co.

Contents

I.	Overview	P. 1
II.	Responses to GAO Questions	
	A. Trading Access	P. 8
	B. Access to Quotation Information	P. 17
	C. Utility of Brokering Services and Quotation Practices	P. 19

These comments and responses are submitted on behalf of Lazard Freres & Co. in response to the Federal Register notice of the General Accounting Office (GAO) published on January 2, 1987 regarding the nature of the trading system for government securities in the secondary market. Lazard is grateful for the opportunity to submit these comments and respond to the inquiries of the GAO. We believe that the results of the GAO's efforts to date coupled with the results of this study will demonstrate the need for further action in the area of government securities trading which will maintain the integrity, stability, and efficiency of those transactions and will insure the existence of fair, honest and liquid markts in such securities.

Our responses will address the specific questions which have been posed by the GAO. Initially, however, the comments will present a brief summary of the reasons why the exclusionary practices which limit access to trading in the secondary market for government securities cannot be justified. Briefly put, the continued existence of an inside market, access to which is limited arbitrarily without regard to financial soundness and suitability for trading, should no longer be tolerated.

The background statements made in the GAO Federal Register notice show that GAO well understands the functioning of the secondary market for government securities. It should be emphasized that although two brokers of government securities do permit access to both screens and trading to non-primary dealers, these brokers account for only a small, certainly less than 10 percent, portion of the total government securities market. Therefore, they do not overcome the significant competitive disadvantages

to which non-primary dealers are subject as a result of their lack of access to the inter-dealer broker screens.

The fundamental nature of the brokers may properly be characterized as the equivalent of an "exchange." Richard A. Spelke, of the Security National Bank of Los Angeles, a former parent of one of the involved brokers, has well stated that "...brokers are, in effect, an exchange. They provide the Treasury bond market with the same service that the New York Stock Exchange provides to the equity market." Because of this exchange function, it is wholly inappropriate to limit access to the "exchange" on an artificial basis. This private club approach to the enormous and vitally important securities market has limited the depth, breadth and resiliency of the secondary market for government securities with the inevitable result that transaction costs are higher than they should be. The system should be opened up so that all who are qualified are permitted full access to the trading system. This would inevitably lead to a more liquid and better functioning government securities market. This approach will benefit both investors in the market and ultimately the government itself, since the net effect will be to drive down the cost of borrowing by the government.

Because Lazard and other non-primary dealers are denied access to trading through the brokers on a fair and equal basis, they are handicapped in assessing the precise market price of securities at any given moment and also are unable to trade at those prices efficiently. Instead, non-primary dealers must go through a primary dealer, both for the purpose of exploring for the real or "inside" prices, and to make trades. This is

a major competitive disadvantage. Primary dealers are often a part of the very competitive forces which are in a position to exploit the knowledge of how a major non-primary dealer is attempting to operate in the secondary market. A further ironic result is that non-primary dealers often must do business with primary dealers who are less creditworthy than themselves.

The secondary government securities market now functions in a manner which would be analogous to restricting access to the stock exchanges only to dealers who participate in initial offerings. For example, if a group of forty firms were to participate in selling a new issue of General Motors stock, these firms would thereafter be the only firms allowed to trade that stock on the New York Stock Exchange and anyone seeking to buy or sell those stocks would have to deal with them. This is an absurd proposition and would not be tolerated in the exchanges and it should not be tolerated in the secondary market for government securities.

An additional burden placed upon the non-primary dealers as a result of the existing system is that they must pay commissions which are greater than those paid by the primary dealers. This is a matter of some economic significance. Again, however, the principal costs to the non-primary dealers are the competitive disadvantages that flow from not having immediate, up-to-date price information; not being able to effectuate trades as efficiently as the primary dealers; and the requirement that many trades be effectuated through a potentially hostile competitor on a disclosed basis.

To illustrate this latter point, consider the problem of Lazard undertaking to assemble a substantial block of government

securities for the purpose of carrying out a particular transaction with a customer. Given that the brokers which do permit access by non-primary dealers account for a small percentage of the government securities brokered inter-dealer daily, it is extremely difficult for substantial blocks of securities to be assembled on a timely basis through those brokers. Therefore, it is necessary to deal with the primary dealers who may discern not only the character of the securities involved in the transaction, but perhaps the ultimate customer, with the risk that they will simply take over the transaction for themselves or otherwise frustrate the proper handling of the transaction.

In summary, by legitimizing an insider market for the public debt, the current system does not provide a level playing field and makes it impossible for a non-primary dealer to compete on an equal basis with the primary dealers in the secondary market. This system serves to stifle competition and inevitably causes transaction costs for government securities to be higher than they would be in the absence of this cartel type arrangement.

It is not Lazard's intention to quarrel with the system insofar as the Federal Reserve Bank of New York (FRBNY) selects those dealers with whom it will trade. The FRBNY should be free to select those with whom it will deal to effectuate monetary policy and can meet such reasonable criteria as the FRBNY may impose. Lazard's complaint is that the FRBNY's system for designating those with whom the bank will trade has been misused to frustrate competition in the secondary market. This misuse is fundamentally at odds with the basic concept that there should be no arbitrary

constraints on access to any trading system and in particular, there should be no arbitrary restraints on access to trading in any equity or security of the U.S. Government. This principle has been recognized by many including John Niehenke, who as acting Assistant Secretary of the Department of the Treasury stated: "It is the public policy of the United States Government to have a market which we refer to as open access, that is, that any party, any individual, any dealer, any investor may participate."

The FRBNY never intended that its primary dealer list should be used as a rationale for limiting access to trading in the secondary market and has so stated. Further, the rationale which is so often used by the primary dealers that this is a legitimate means of assuring the credit-worthiness of those with whom they trade through the broker screens has been disavowed by the FRBNY. The FRBNY has clearly stated that the list of primary dealers is not intended to be an affirmation of creditworthiness of those who have been given primary dealer status. Indeed, from time to time, the Bank has refused to do business with given primary dealers because of a weak financial condition but there has been no public disclosure of these situations.1/ Therefore, the rationale to which the primary dealers and brokers continue to cling is empty, as even they have no way of knowing when the FRBNY has found a particular dealer to be in an unsound financial condition.

1/ See testimony of E. Gerald Corrigan, President FRBNY before the Committee on Banking, Housing, and Urban Affairs; United States Senate and responses to questions of Senator Alan Cranston; May 9, 1985; S. Hrg. 99-161, p. 136.

During the course of public and private debate on this issue, a number of other arguments in support of the current exclusive system have been made. They should be reviewed briefly. One argument which has been stated to Lazard and which has been repeated in hearings before Congressional Committees is that primary dealers should be permitted to use an exclusionary system in the secondary market as a reward for their participation in the primary market. The essence of this argument is that primary dealers take greater risks and have other obligations in dealing with the government and therefore should be entitled to greater profits by restricting competition in the secondary market.

The argument is nonsensical. Those institutions which have chosen to become primary dealers have done so in their own economic self-interest. They are in the primary dealer market to make a profit in that market; they certainly do not participate as an exercise in partiotism or with a belief that they are doing so only because this permits them access to a more profitable restricted secondary market. Primary dealers make money in dealing with the government, as is entirely proper, but there should be no illusions about the profit motivation of the primary dealers.

By contrast, Lazard has made a decision not to seek primary dealer status. Lazard is not interested in that portion of the market consisting of direct dealings with the government. Lazard is active in many areas of government securities trading however, especially the placement to the end buyer of long-term U.S. Treasuries. This rational decision by Lazard should not

be penalized by the denial of full access to the secondary market.

In any event, the stating of the argument reveals the extent to which it is utterly inimical to our economic principles. Our economic system does not allow a particpant to enjoy a monopoly in a given area of the economy because of allegedly greater risks taken in some other area of the economy. It is absurd to suggest that monopoly profits be granted in a given field because of a contention that certain institutions take risks in some other field.

Finally, attempts have been made to support the monopolistic system by emphasizing that the system of blind brokering requires that dealers have confidence in the financial wherewithal and integrity of the other dealers with whom they are trading. It is contended that limiting access to primary dealers provides this assurance and is therefore permissible. Lazard agrees that blind brokering is an advantageous element of the system of trading securities in the secondary market. Further, Lazard agrees that it is necessary to have a system which permits those who are trading to have confidence in those with whom they are dealing. This, however, provides no rationale for limiting trading to primary dealers. Rather, a system should be devised so that all who meet the financial and other standards are permitted equal access to the screens and to the trading of government securities.

TRADING ACCESS

1. How important is blind brokering for the efficiency/and liquidity of the government securities market?

Blind brokering is important to the liquidity and efficiency of the government securities market. Blind brokering on the inter-dealer broker system has significant advantages, particularly when there are two different systems. The existence of the system for some dealers and not for others gives an unfair advantage to those who have access. In testimony before the House Subcommittee on Domestic Monetary Policy, a representative of the Primary Dealers Committee acknowledged the competitive advantage of those with access to blind brokering and stated that he would be unwilling to trade without the benefit of limited access blind brokering.2/

It is also important to recognize that the broker is not "blind." The broker knows both sides of the transaction and along with the dealer, should be subject to normal standards of prudence in carrying out trades. A broker is aware of the nature of each dealer and should be expected to monitor and restrict trades of a size or nature which are questionable for a given dealer. This is an important element of blind brokering.

The FRBNY has stated that it discontinues trading with dealers on its primary list out of concerns over a firm's ability to meet its obligations, and without public notice. In a similar

2/ Testimony of Richard M. Kelly, Primary Dealers Committee, before the House Committee on Banking, Finance, and Urban Affairs; Subcommittee on Domestic Monetary Policy; July 9, 1985.

manner, brokers doubtless use their superior knowledge about a firm's trading positions to limit trading in some instances. Dealers may also instruct brokers to limit transactions with particular counter-parties if there are doubts about a particular party's ability to complete a transaction. These actions, coupled with the credit default free nature of government securities, causes Lazard to doubt that blind brokering alone is essential to the liquidity and efficiency of the government securities market.

The current system of arbitrarily limiting blind brokering for the majority of government securities to primary dealers in fact decreases liquidity. Many dealers, not trading on the screens, are nevertheless able to provide an expanded market for U.S. government securities and they should be permitted to function effectively in the market.3/

2. What are the costs and benefits of the current system of limited access blind brokering? What alternative arrangements, if any, should be considered? How do their costs and benefits compare with those of the existing system?

The cost of the limited access system, in the form of higher transaction costs, are passed on systemwide to the buyers and sellers of government securities, e.g. U.S. Treasury, Federal Reserve, pension funds, municipalities, individuals, etc. The benefits accrue to those "on" the system. More specifically, the greater transaction costs take the form of wider spreads between the bid and the ask price, additional broker commissions and price distortions due to a two-tiered system.

3/ See testimony of E. Gerald Corrigan; Senate Committee on Banking Housing and Urban Affairs, S. Hrg. 99-161, May 9, 1985, p. 88.

Many purchasers of government securities believe that only primary dealers are credit worthy, a false notion created and nurtured by those "on" the system, and will not trade with others. This so-called "drift to perceived quality" imposes real, adverse financial consequences on non-primaries in the form of business opportunities lost and current business shifts. This narrowing of the market results in higher transaction costs for government securities to the detriment of the public. Ultimately, the Federal Government also bears increased costs in financing the debt.

The benefits of blind brokering with non-discriminatory access clearly exist although they are difficult to quantify precisely. (see testimony of Corrigan, Senate Banking Committee). The benefits would exist in the form of more participants placing the debt of the U.S. Government, thereby inevitably expanding the market for U.S. securities, and ultimately increasing liquidity systemwide. Screen traders have smaller costs overall due to the relative ease and efficiency with which the market can be surveyed and the speed with which trades can be executed. Non-discriminatory access permits these advantages of the system to be broadly realized.

3. Of the considerations influencing screen broker decisions on which firms should have access, which do you feel are relied on most heavily and which least heavily? Is this appropriate? Please explain.

As non-primary respondents, it is difficult to state with certainty which considerations are paramount. Great reliance appears to be placed on primary dealer status although according to the questionnaire responses (GAO September, 1986) the criteria

"meeting of minimum credit requirements imposed by other dealers which trade through brokers" received the single greatest response from primary dealers. Therefore, creditworthiness appears to be the single most important criteria. Because it is crucial that the parties have a high level of confidence that the counterparty can complete a transaction, it is very appropriate that creditworthiness is relied on heavily. Given the restricted scope of oversight of the FRBNY and the misperception of FRBNY guarantee of those that are primary dealers, any criteria other than creditworthiness (such as primary dealer status) should be irrelevant.

4. What are the consequences of current access practices for the liquidity and efficiency of the market and for various market participants? In your answer, please distinguish carefully between types of dealers and investors.

The aura of quality and creditworthiness created by the unjustified use of the Fed's list of primary dealers has caused a migration of investors (primarily institutions, pension funds) away from non-primary dealers toward primaries. As a result, the number of participants in the market has been artificially restricted at the secondary level and artificially expanded at the primary level. This phenomenon is reflected in the responses to the GAO's survey. Two thirds of the non-primaries believed it likely or highly likely that increased access would lead to increased liquidity in the government securities market.4/

There are other very real practical consequences for non-primaries. As noted above, efforts expended to limit the market translates into competitive disadvantages for non-primaries.

4/ GAO/GGD-86-147FS-Dealer Views on Market Operations and Federal Reserve Oversight, Appendix IV, question 31, p. 54.

Primary dealer responses to the GAO survey confirm this advantage. Fully 84% of the primaries believe that the screens provide at a minimum some competitive advantage. Five primary dealers believe the screens provide at least a great competitive advantage.

5. What risks are associated with blind brokering? Who bears these risks? Do the risks necessarily increase when the number of dealers trading on the system increases? What alternatives exist to control these risks? Which, if any, of these alternatives provides an acceptable level of risk control at a reasonable cost?

There are very few, if any, risks associated with blind brokering as to any particular transaction. All transactions are quickly closed. Because they involve government instruments there is virtually no credit default risk in the instrument itself, although its value may change.

There is some dispute as to who bears the risk in the event a dealer cannot complete a transaction. The inter-dealer brokers insist that they act only as agents and that all risk of the failure of a particular dealer to make good on a trade rests with the other party to the transaction. The dealers likely do not accept this proposition. In practice, losses resulting from failed trades have been shared between the broker and the dealer. What must be emphasized is that the broker, even if only an "agent", is bound to exercise standards of prudence and a failure to do so subjects the broker to the financial consequences of that dereliction. An increase in the number of dealers does not necessarily lead to an increase in risks. Brokers with "open" access successfully deal with as many as 200 dealers. As long as dealers are creditworthy and brokers and dealers alike exercise prudence, the risks can be controlled.

To the extent additional assurances regarding risk reduction are required, the Federal Reserve Bank of New York could permit non-primaries to submit to the same reporting practices imposed upon primaries. Lazard volunteered to submit reports daily to gain screen access but was rejected by FRBNY.

Promulgation by the Treasury of its rules implementing the Government Securities Act of 1986 is yet another convenient alternative standard. A Treasury standard might also answer the objections of the FRBNY that additional responsibilities in this area would interfere with its monetary policy functions. So long as appropriate entry requirements and disclosure standards are imposed there should be no appreciable increase in risks by a discontinuation of the system of arbitrary limitation to primary dealers.

As discussed above, brokers must use prudence in carrying out trades. Permitting creditworthy dealers access to the broker system would not increase risks. Those brokers who have permitted full access have demonstrated that trading can be carried on as a principal without disruption, or unacceptable risks and costs.

6. For what reason do you consider it acceptable or unacceptable for brokers to require new customers to first have a business relationship with the FRBNY as a primary dealer or to be an aspiring primary before it will consider the customer's application for access? To what extent, if any, does your answer depend on your perceptions of the FRBNY business relationship with primary dealers? If it does, what aspects of the relationship are most important?

It is not acceptable to require primary dealer or aspiring primary dealer status for screen access because that

status is neither a guarantee of credit worthiness nor an assurance of continuing stability.5/ Reporting requirements of many secondary dealers under other regulatory systems are more complete and reflect a dealer's total portfolio more accurately than reports to the FRBNY. As an example, a former primary dealer Continental Illinois, was brought down by non-government securities portfolio problems, while it was a primary.

Other than capital requirements, there are no FRBNY requirements that are of any overwhelming relevance to trading access in the secondary market. It is also pertinent that the FRBNY has a business relationship with the primary dealers which makes it an unlikely watchdog of its "customers." Because the primary dealers are customers there is an inevitable tendency for the FRBNY to favor those customers, and to do nothing to disrupt its relationship with them.

7. What would be the consequences if the list of dealers with trading access to interdealer screen brokers were to diverge significantly from the list of primary dealers? Would brokers allowing expanded access lose business? If they did, would the loss of major market participants from the screen brokering system make it harder to sell the public debt or to conduct monetary policy? Would risks in the interdealer market increase significantly? To what extent might any cost of allowing such access be offset by any benefits from greater participation by other dealers in these systems?

As long as credit worthiness standards were maintained, any consequences of an expanded list would be beneficial. The breadth, depth and resiliency of the market would be increased with the addition of more sufficiently capitalized firms. In addition, public perception about the quality of those dealers

5/ Corrigan, Supra note 3.

would be affected favorably. Commissions to dealers and transaction costs to buyers and sellers in the secondary market would be reduced. It is likely that brokers would experience an increase in transactions. Some disgruntled primaries may spread the perceived risk resulting from an expansion of dealers on the screen by diverting some of their transactions. This would create business for other brokers. Such a spread would be beneficial regardless of how perfect the primaries perceive the current system to be. There is no basis for concluding that it would in any way effect adversely the ability to sell the public debt or effectuate monetary policy; to the contrary, it would help those efforts by expanding the number of "perceived quality" dealers able to trade based on the best market information.

8. Under what conditions, if any, should firms who are neither primary dealers nor aspiring primary dealers but who specialize in certain segments of the Treasury, agency, or mortage-backed securities markets, be able to obtain trading access to the interdealer broker screens for segments of the market in which they specialize? Would greater availability of limited access arrangements for such dealers affect the overall depth and liquidity of the markets? Please explain.

It is true that some dealers specialize. Specialization is a product of the classic economic theory of comparative advantage which leads to the optimal allocation of resources. However, if trading access were permitted solely for these specialties, niches could develop leading to market distortions. Specialized dealers with access limited only to certain issues would not be able to hedge to limit their risk or arbitrage away inefficiencies in the broader market. All markets are ultimately interrelated and, although it is technically feasible to divide up markets for limited access, we urge caution in this area.

9. The Treasury Department must adopt rules for brokers and dealers, including rules for financial responsibility. Would you expect these rules, and the associated enforcement of them by the appropriate federal regulator, to affect access to interdealer broker trading systems? In answering these questions, what assumptions have you made about whether interdealer brokers are acting as agent or principal?

Proposals for financial responsibility will unlikely be any more complete or detailed than rules currently covering dealers in the financial markets. The exception will be for those primary dealers who have not been subject to any controls as a result of dealing solely in previously unregulated government securities. Ironically, the FRBNY reporting requirements for primaries are far less comprehensive than the reporting requirements that many federal regulators require of dealers in financial markets. As a result, most non-primaries come under far more scrutiny than would be imposed by the FRBNY alone. If capital adequacy is the primary concern of the interdealer broker, the new rules may demonstrate the naivete of those who rely on the FRBNY oversight and reporting requirements alone for financial capability and therefore may further erode the justification for the current exclusive system. The rules could provide an opportunity to terminate the limitation on access, i.e., by the imposition of sufficiently stringent standards so that the limitation could no longer be defended. Because access may not be a free market decision by the brokers, however, it is doubtful that these additional requirements alone will result in expanded access. We hope the Treasury will consider as part of its rules, an access requirement for those dealers who are registered under the Act.

10. Would development of a netting system for clearing and settling government security trades affect the risks faced by screen brokers and their customers? How, if at all, would you expect such developments to affect access to interdealer broker trading systems?

The development of such a system would be a positive development, removing another justification for the current restrictive system. Those most closely associated with the current system should be looked to for further comment. In any event, removing the current restrictive trading system for government securities cannot await the development of such a system.

11. How might actions designed to reduce daylight overdraft exposure now being considered by the Federal Reserve System, affect your assessment of the blind brokering system and access to it?

The current efforts to reduce the mis-matching of trades is worthwhile but would have little effect on the access issue. To the extent that it brings about a more orderly market, it further weakens the case for the current system of arbitrarily limiting access.

ACCESS TO QUOTATION INFORMATION

1. What type of customers, if any, who cannot trade on interdealer screens should have access to such information? In your answer, please be specific concerning the type of customer and consequences for the market.

Any customer should have access to quotation information. The increased availibility of information can only serve to further competition in the trading and sale of government securities. Participants such as pension funds should be able to purchase

and trade government securities in a "sunshine" environment. Enlightened, intelligent decision making will produce greater confidence which in turn, would add to the resiliency, breadth, and depth of the market.

2. What would be the benefit and costs of making information from interdealer brokers available to parties without trading access? Would interdealer brokers have the legal right to sell or divulge such information? If so, how should the dissemination costs be paid?

The costs of making information available should not be substantial and could be paid for by appropriate fees. To be useful, it should be available on a real time basis. There would appear to be no legal impediment to the divulging of this information. It is noteworthy that the retail brokers do sell their information, giving primary dealers the option of viewing even more pricing information, while the inter-dealer brokers do not distribute their information.

3. Would public dissemination of the information displayed on interdealer broker screens overcome a substantial portion of the concerns about limited trading access? Please explain.

The public availability of trading information on a real time basis would perhaps cut the opportunity costs associated with dealing in a market where competitors potentially hostile to your position possess superior trading information. Such a step (public availability) is not, however, sufficient to cure the problem. Non-primary dealers need to have not only the information but the ability to trade on an equal information basis with the primary dealers.

4. Do dealers who are able to view the interdealer screens have an advantage in other markets, such as futures or options exchanges, over participants in these markets who are limited to seeing the retail screen? If such an advantage exists, how is it manifested, how significant is it, and should it continue or be eliminated? Please explain.

Interest rate arbitraging is significantly handicapped by a lack of comprehensive trading information. With comprehensive information, risks can be reduced. There is clearly an edge derived from this information in the derivative markets. Other than knowing that it exists, we cannot accurately measusure the value of the edge that the information gap grants to those with access. It is unlikely that the advantage is less than that obtained in the "primary" market as reflected in the primary dealer responses to question 32, appendix III of the GAO report of September, 1986.

5. Is the information on market prices currently collected and published by the Federal Reserve useful? Please explain.

The information is useful only as a matter of historical information; it has no value in real time trading.

UTILITY OF BROKERING SERVICES AND QUOTATION PRACTICES

1. In the government securities market, how do investors evaluate the terms and conditions on which their trades were executed?

Timeliness of execution, price, quantity, and service are the primary criteria that investors use in evaluating the execution of trades. Increased access to complete trading information would lead to more competition among dealers as well as innovation in serving customers.

2. Discuss any aspects of broker or dealer practices, not previously mentioned, that might be viewed as inconsistent with the principles of investor protection and the maintenance of fair, honest, and efficient markets? What, if anything, should be done about these practices? What are the costs and benefits of any such actions?

No Comment

3. Please describe any characteristics and practices of other markets that are appropriate benchmarks for evaluating the reasonableness of broker service and quotation availability in the government securities market.

In the corporate bond market trading is "blind", brokers act as principals and this market functions smoothly without the exclusion of all but an arbitrarily chosen group of dealers. Moreover, this market has some greater risks, e.g. longer settlement dates, default-risky instruments etc. Although the current system in which the exact status of government securities brokers is uncertain (do they act as agents only or as principals) this does not preclude broadening access. The frank acknowledgement of their role as principals or at least as agents who must exercise a high level of prudence would remove one more prop used by the brokers to support the current unfair system. Even if one were to assume that the brokers now act only as agents, this does not relieve them of all responsibility for maintaining sensible trades. An agent has the responsibility to act prudently to protect the principal from harm. There is, therefore, considerable merit in treating all brokers in the government securities market as principals in the same manner as they are treated in the corporate bond markets.

APPENDIX III

COMMENTS SUBMITTED BY FIRST BANK SYSTEM CAPITAL MARKETS GROUP

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FBS Capital Markets Group

First Bank Place
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612 370-4151

January 22, 1987

Mr. Craig A. Simmons
Senior Associate Director
General Government Division
U.S. General Accounting Office
Room 3862
441 G Street, NW
Washington, D.C. 20548

RE: File No. 233175

Dear Mr. Simmons:

I welcome the opportunity, on behalf of First Bank System, Inc. to furnish comment on the General Accounting Office's study of the current trading system in the secondary market for U.S. Government Securities.

First Bank System, Inc., is the 15th largest bank holding company in the United States comprised of First Bank Minneapolis, First Bank St. Paul and 77 other banks and trust companies, with 150 banking offices in Minnesota, North Dakota, South Dakota, Montana, Washington and Wisconsin, and a trust company in Florida. The company also provides financial services through a number of domestic and international subsidiaries and offices. These services include trust, international banking, commercial and agricultural finance, data processing, insurance brokerage, leasing, mortgage banking, venture capital, merchant banking and brokerage services.

Comments on individual aspects of the proposal have been made on separate pages to facilitate your staff's review. Comments are organized to follow those questions raised in the text which has been published in the Federal Register. We have also included some general comments on issues which are not addressed but which have an important bearing on the subject. These "Additional Comments" follow our responses to the stated questions.

Again, we appreciate having the opportunity to furnish comment, and if you or your staff have any questions, please feel free to call me at (612) 370-4527.

Sincerely,

Michael G. Stout
Executive Vice President
First Bank System
Capital Markets Group

Trading Access

Question #1

How important is blind brokering for the efficiency and liquidity of the government securities market?

- Blind brokering is essential for an efficient, liquid government securities market. The investor's interest can only be served by anonymous access to the market. If such anonymity is not preserved, market prices will temporarily and unjustifiably be bid up (on the rumor of a large buy order) or down (on the rumor of a large sell order) by speculators. Speculators are a necessary ingredient to an efficient market but have no place in raising transaction costs for the final investor.

Question #2

What are the costs and benefits of the current system of limited access blind brokering? What alternative arrangements, if any, should be considered? How do their costs and benefits compare with those of the existing system?

- The benefits of the current system of "limited access blind brokering" are of two types: those benefits accruing to the dealers and those to the investors. The dealer, via blind brokering, can transact business for the customer on an anonymous basis. The investor, however, cannot objectively verify market prices, given the limited access system. This is of benefit to the dealer. Because the investor cannot view the broker screens, he cannot ascertain with any degree of certainty what is happening in the market as his business is being transacted.

- Such screen viewing is for the "dealer" only and is of benefit to the dealer. It is the equivalent of insider information. In sum, the investor has poor information upon which to make a judgement as to whether or not he/she obtained efficient execution. It is tantamount to executing a trade on the stock exchange without the benefit of the tape.

- The current system lends itself to abuses since all participants do not have equal access to the best bid or best offer.

- The current system goes a long way in insuring creditworthy counterparties within the dealing community. This is because all dealers are approved by the Federal Reserve, not because the brokers have extraordinary business judgement. There are many firms, however, that could meet or exceed the creditworthiness of the dealers that are not allowed accesss to the brokering system. More creditworthy firms would add to the efficiency and liquidity of the market. Because of the limited access to the market, these firms are not present in their most efficient and beneficial form. This therefore represents a cost to the market and other investors.

- The monitoring of the primary dealers by the Federal Reserve is arguably of benefit to the investor. The monitoring of dealers by the NASD is also beneficial. It would seem, however, that the monitoring of more than just the primary dealers would be of greater benefit.

- The current system does not address the possible problem of dealers repaying brokers for favors, entertainment, etc. It also leaves room for choosing a broker based on personal relationships. This can cost the market participant efficient execution. Perhaps a clearing corporation would be more efficient, i.e., a black box.

- It is argued that one of the benefits of the current system is market making by the primary dealers. Market making does not, however, necessarily mean liquidity in a strict sense. This is because the best price will be made by the counterparty that has an economic need to do the opposite side of the investor's trade. It is unlikely that such a counterparty will always be a primary dealer. With more participants using the blind brokering system, the need to make markets in issues that a dealer has no involvement in is lessened. This leads to the added benefit of lowering the dealer's risk profile which enhances creditworthiness.

- The net result of the foregoing narrative is that the system can be improved by:

    a. adding more creditworthy participants to the execution side with such additions to be accepted based upon specified financial criteria.

    b. making broker screen information available to all participants.

JAN 2 3

Question #3

Of the considerations influencing screen broker decisions on which firms should have access, which do you feel are relied on most heavily and which least heavily? Is this appropriate?

- In our opinion a limited access screen broker's decision about to whom to allow access is decided overwhelmingly by how much of the key primary dealer's business he will lose by allowing XYZ company access if other limited access brokers do not allow XYZ company access. Creditworthiness is an important question but much less so than the above. A prime example of creditworthiness being a secondary consideration: Continental Illinois has always had access to the limited access broker's market even during the 1982-1985 crisis when the FDIC effectively oversaw the management of Continental. Despite being bankrupt, Continental's dealer operation never lost its limited access broker wires or its ability to transact in those markets.

- The brokers contend that they must be able to represent to their customers that, whomever their counterparty through the blind brokerage, such counterparty is creditworthy. In addition, the brokers themselves want to deal with creditworthy firms. We agree that both concerns are real and valid.

- Both concerns can be addressed easily by requiring as a prerequisite to trading access that all firms meet and maintain the specified financial conditions tests.

- The brokers compete for customers who have a sufficient volume of business to pay for services provided. If we wanted to design a system that insured broker profits, we certainly could do so by having the brokers specify minimum trading volumes for access to the system. We believe, however, that mandating broker profitability is not in the public interest. In addition, there exists a broker (Cantor Fitzgerald) that deals with more customers than just primary dealers. It maintains a high level of profitability. For low volume customers they have screen charges, etc. This makes the primary brokers' volume concerns look self-serving at best.

- The primary brokers are concerned that their service quality will suffer if more customers are served. It is difficult to imagine an organization that would not expand its capabilities given increased demand. While structurally this cannot be accomplished overnight, it certainly can be accomplished over a reasonable time period. Cantor Fitzgerald serves many more customers than the primary brokers and maintains a high level of service quality. Apparently service quality is not directly proportional to the number of customers served.

- The primary brokers find comfort in the fact that the Federal Reserve monitors primary and aspiring primary dealers. There is no reason to believe that the brokers wouldn't be comfortable with other regulatory bodies such as the OCC or NASD or MSRB. More importantly, there is no reason to believe that the primary dealers wouldn't take comfort in dealing with financially sound firms governed by other (or the same, for that matter) regulatory agencies. With a governing regulatory body and proper financial ratios, there is every reason to believe that blind brokerage works well. Witness, again, Cantor Fitzgerald.

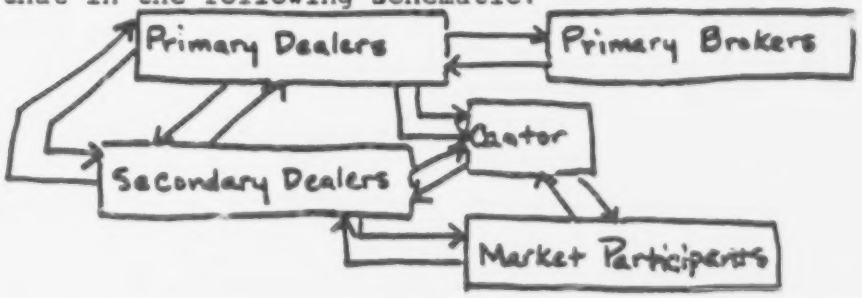
JAN 2 8 1993

Question #4

What are the consequences of current access practices for the liquidity and efficiency of the market and for various market participants?

- Limited access to broker markets denies the paring of the best bid with the best offer. Most primary reporting dealers simply broker large portions of their customer business anyway. The market is therefore less efficient and potentially less liquid. Denying equal access to the best bid or offer and to the best market information deprives most, if not all, end users of the crucial information needed to make efficient investment decisions.

- Currently, relationships in the market can be viewed as that in the following schematic:



- The current arrangement has provided for an efficient and liquid market. That is not at issue. What is at issue is whether or not the market could be more efficient and more liquid. As can be seen in the diagram, primary dealers have access to all parties in the market. This is not true of the secondary dealers or other market participants. The greatest volume traded occurs between primary dealers via the primary brokers. This volume represents a funneling of inquiry from all market participants and secondary dealers. In essence, what we currently have is an oligopoly of primary dealers preserved by a more concentrated oligopoly of primary brokers. What separates the primary and secondary dealers is not economic factors, but structural barriers i.e., barriers to entry. Economic theory suggests that when barriers to entry exist, a monopoly or oligopoly exist in which free market price setting is impaired and the market becomes inefficient. Certain barriers, such as a measure of creditworthiness, are necessary. It seems hard to argue that primary brokers' business decisions backed by primary dealers' business decisions are necessary barriers to entry.

JAN 2 6 1987

- To increase efficiency and liquidity requires a greater number of participants. A greater number of broker/dealers means more competition, better dissemination of information, and more marketmakers. Would anyone argue that the Bond Futures trading pit in Chicago would be more efficient and liquid with <u>fewer</u> participants?

JAN 2 8 1987

Question #5

What risks are associated with blind brokering? Who bears these risks? Do the risks necessarily increase when the numbers of dealers trading in the system increase? What alternatives exist to control these risks? Which, if any, of these alternatives provides an acceptable level of risk control at a reasonable cost?

- The risk associated with blind brokering is essentially counterparty credit risk. This risk must be borne by those dealers which are party to the system. This risk can be lowered by requiring all dealers in the system to maintain specified financial ratios, capital positions, etc. Maintaining these levels would present a barrier to entry for some firms. However, such barriers would be in the public interest and would allow more participants into the system than are now permitted.

- More participants would require an expanded periodic credit review process. This credit review process could be done by existing brokers (most probably with existing personnel), given uniform reporting requirements. Better yet, a clearing house arrangement such as employed by the CBT or CBOE could be employed. The "exchange" would post, through a "black box", the best bids and offers on all issues and act as agent for all executions. It would monitor all credits. It would charge a fee to all participants to cover costs. Such a black box would close the door to business being done through particular brokers for reasons that are not in the public interest.

Question #6

For what reasons do you consider it acceptable or unacceptable for brokers to require new customers to first have a business relationship with the FRBNY as a primary dealer or to be an aspiring primary dealer before it will consider the customer's application for access? To what extent, if any, does your answer depend on your perceptions of the FRBNY's business relationship with primary dealers? If it does, what aspects of the relationship are most important?

- In our opinion, there exists no free market justification for this requirement There are only thinly argued creditworthiness considerations. There are certainly no monetary policy arguments which could be advanced since the FRBNY implements policy directly with primary dealers rather than through the broker system.

JAN 23 1987

Question #7

What would be the consequences if the list of dealers with trading access to interdealer screen brokers were to diverge significantly from the list of primary dealers? Would brokers allowing expanded access lose business? If they did, would the loss of major market participants from the screen brokering system make it harder to sell the public debt or to conduct monetary policy? Would risks in the interdealer market increase significantly? To what extent might any cost of allowing such access be offset by any benefits from greater participation by other dealers in these systems?

- The markets would gain more depth, liquidity, and efficiency as the number of participants in the interdealer screens expanded.
- If all interdealer brokers expanded access (i.e., broke down the artificial barrier) simultaneously, none of them would lose business; and in fact, all would see an increase in business. If, however, only one or two unilaterally expanded beyond the existing oligopoly, only they would lose primary dealer business and the others still playing the oligopoly game would gain this business. Net, the brokers in aggregate under either circumstance would in all likelihood gain business.
- If screen brokers did lose some of the business of major market participants, it would quickly be offset by new business from other major market participants who were heretofore excluded. There would be no major disruption in the conduct
- If credit standards were agreed upon, credit risk would be minimal. Market risk would be reduced and volatility dampened because the best bids and the best offers would meet more efficiently. This is because all market information would be available to all participants and because the "retail" market would be less prone to manipulation and to "painting the tape," by those participants with access to limited access broker screens.

JAN 2 3 1987

Question #8

Under what conditions, if any, should firms who are neither primary nor aspiring primary dealers but who specialize in certain segments of the Treasury, agency or mortgage-backed securities markets, be able to obtain trading access to the interdealer broker screens for segments of the market in which they specialize?

- Firms who meet the minimum credit standards and whose business involves either Treasury, agency or mortgage-backed securities, should be allowed access to the interdealer brokers' markets and screens. Again, the larger the number of participants in a market, and the more equal the information flow, the more efficient the market is and the less prone it is to manipulation and "insider" trading. Market depth and liquidity would improve significantly.

JAN 2 3 1987

Question #9

The Treasury Department must adopt rules for brokers and dealers, including rules for financial responsibility. Would you expect these rules, and the associated enforcement of them by the appropriate federal regulator, to affect access to interdealer broker trading systems? In answering the questions, what assumptions have you made about whether interdealer brokers are acting as agent or principal?

- These rules would affect access to the interdealer broker trading system. We are assuming that interdealer brokers are acting as agent, not principal.

JAN 2 8 1997

Question # 10

Would development of a netting system for clearing and settling government security trades affect the risks faced by screen brokers and their customers? How, if at all, would you expect such developments to affect access to interdealer broker trading systems?

- A netting system would not increase the risks associated with blind brokering on the part of either the broker or their customers. Access should not be affected at all.

JAN 2 8 1987

Question #11

How might actions designed to reduce daylight overdraft exposure now being considered by the Federal Reserve System, affect your assessment of the blind brokering system and access to it?

- It would have no impact on our assessment of the system or to the access thereof.

JAN 2 9 1997

Access to Quotation Information

Question #1

What types of customers, if any, who cannot trade on interdealer screens should have access to such information?

- Any institution or person willing to bear the cost of the service should have access to interdealer screen information. To mandate that viewing be available only to a defined or designated group serves no better purpose than the current arrangement. Under this current arrangement, such limited access raises barriers to entry--thus preserving oligopoly: and providing for dealer-selected information dissemination at best. Would anyone argue that it is in the public interest to restrict viewing access to the broad tape or commodities screens?

- The ability for any market participant to view interdealer screens has definite positive consequences. Investors would be protected because it offers objective market information that can be used to formulate investment strategies, to verify efficient execution, and to effect real-time market reactions to current news. It also provides for more efficient price competition since market players can verify prices and price movements.

JAN 2 8 1987

Question #2

What would be the benefits and costs of making information from interdealer brokers available to parties without trading access? Would interdealer brokers have the right to sell or divulge such information? If so, how should the dissemination costs be paid?

- Information dissemination costs should be paid for via a fee. A marvelous guide for the fee-based dissemination of information is the retail broker, Cantor Fitzgerald. With five to six brokers engaged in the business of providing viewing access for a fee, it would seem that competitive pricing of the service would result.

- Viewing access is much less costly to provide than dealer access because it is a passive service, much like a Dow Jones News Jet. It can thus be expanded rapidly, requiring but a screen and dedicated phone line, both of which are readily available almost anywhere.

JAN 2 9 1987

Question #3

Would public dissemination of the information on interdealer broker screens overcome a substantial portion of the concerns about limited trading access?

- Public dissemination of information displayed on dealer screens is a first step toward the dissolution of the primary dealer oligopoly. Objective price and market volume verification would then be available. This would make the market more efficient and liquid. However, by not expanding trading access to all entities that can pass uniform specified credit tests, efficiency and liquidity will not be enhanced to the fullest extent possible. This is because of the multiple levels that inquiry must now be processed through.

- Currently, market participants can either do business immediately through the retail broker (Cantor Fitzgerald) or indirectly through dealers (secondary and primary, perhaps) to get execution through the limited access primary broker screens. Thus, the current system funnels all non-Cantor business through the primary dealers, then through the primary brokers. Two things happen here. One, because only primary dealers may use primary brokers screens, market participants are forced to deal through an intermediary. Dealing through an intermediary is not, a priori, a bad thing. The mandating of such dealing is inefficient and wasteful because it unneccessarily adds another layer in between the transaction and the market. Second, since only primary dealers may view the screens, all non-primary dealers have no way to objectively verify price.

JAN 2 3 1987

Question #4

Do dealers who are able to view the interdealer screens have an advantage in other markets, such as the futures or options exchanges, over participants in these markets who are limited to seeing the retail screens? If such an advantage exists, how is it manifested, how significant is it, and should it continue or be eliminated?

- Dealers that can view the interdealer screens have an advantage in all related markets over participants that can only view retail screens. They are the only market participants that can view the "real" market, ie. the price and volume action of the majority of the cash business transacted. They often obtain such information first and disseminate it at their discretion. Even if primary dealer policy was to disseminate all price information (an impossible task short of providing viewing access), such information would always be second-hand. Given first-hand price and volume information, the primary dealers can position themselves first for entire market sector moves. Having positioned themselves in front of the vast majority of market participants, they can then let the information prompt other nonprimary dealer participants to position themselves in a like manner and thus profit. This is tantamount to trading on insider information and may hardly be viewed as being in the public interest.

- The positioning mentioned above could be in futures, options or cash markets. It normally would be in that market which most fully takes advantage of the given information.

JAN 23 1987

Question #5

Is the information on market prices currently collected and published by the Federal Register useful?

- The information on market prices currently collected and published by the Federal Reserve is useful in a general-context manner. It aids in the building of historical price information data bases, etc. It is not useful for making buy/sell or strategy decisions on a day-to-day basis. Only current market information can guide that process.

JAN 2 8 1987

Questions #1,2 & 3

In the government securities market, how do investors evaluate the terms and conditions on which their trades were executed?

Discuss any aspects of broker or dealer practices, not previously mentioned, that might be viewed as inconsistent with the principles of investor protection and the maintenance of fair, honest, and efficient markets? What, if anything, should be done about these practices? What are the costs and benefits of these actions?

Please describe any characteristics and practices of other markets that are appropriate benchmarks for evaluating the reasonableness of broker service and quotation availability in the government securities market.

- Currently, investors must evaluate the terms and conditions on which their trades were executed on the basis of information provided by primary dealers second-hand or by viewing the retail broker screen (Cantor Fitzgerald) which can and frequently is manipulated by a primary dealer to show whatever the dealer wants it to show. This manipulation can be accomplished for two reasons:

    1) The retail screen does not account for the majority of the business transacted.

    2) Only the primary dealer knows first-hand what the majority of the market is doing.

- For example, suppose an investor, who has a Cantor screen, calls a primary dealer for an offering on 10 million four-year notes. Suppose further that Cantor shows the price at 100 2/32-6/32 and the primary broker screen shows the price at 100 2/32-4/32. The dealer could sell the 10 million to the account at 100 6/32, buy back 9 million at 100 4/32 in the primary broker screens (netting 2/32 per million) and buy back one million in the Cantor screen at 100 6/32 (breaking even on one million).

- Let us analyze what has happened here. The securities are offered better on the primary broker screens in this particular instance. This is because a primary dealer or a customer of such a dealer has four year notes it wants to sell (known as an axe in the issue).

JAN 2 8 1987

The buyer cannot, in this instance, get in contact with the party that has a need to sell and thus does not get the best price. However, because the purchaser cannot have access to the primary broker screens, it does not know this. What it does know is that someone is buying four year notes in Cantor at 100 6/32 and it just purchased the same securities at 100 6/32; therefore, it paid the "right" price. However, it was the dealer in this instance buying from Cantor Fitzgerald to "paint the picture" of the right price. In reality, the securities could have been bought at 100 4/32. The dealer made $5,625.00, or (9 * 2/32 * 312.50) risk-free because it had insider information! What did the dealer do in this instance that was in the public interest? Had the purchaser been able to access the primary dealer market directly, it could have bought the securities at 100 4/32.

JAN 2 8 1987

Additional Comments

A. The primary dealers invoke three arguments to support their contention that the OTC market for U.S. Government Securities should be left unchanged. These arguments are, in reality, contentions.

The primary dealers contend that:
(1) they underwrite the Treasury's auctions.
(2) they make markets in all Treasury securities.
(3) they are indispensable for the execution of the Fed's monetary policy.

We shall address these in turn.

- While it is clear that the primary dealers play a large role in Treasury auctions, it is less clear to most observers why they warrant this exclusive privilege. First, primary dealers are not final users of Treasury securities. Investors are. Second, dealers have access to the pictures that tell the true story about the market. The investors do not. Therefore, in order for the final user, the investor, to find out at what price the to-be-auctioned securities are trading, and therefore what price to bid in the upcoming auction, he/she has to contact a primary dealer and ask for that information.

- The primary dealer, because of its access to the equivalent of insider information, becomes a depository of auction interest information. If auction interest is very strong, the dealers can bid up for the securities in the auction, own the majority of it, and then retail it out at a profit. Equivalently, they can sell the majority of the issue to the final investor during the when-issued period and then cover their shorts by purchasing the majority of the auction. The opposite can be accomplished if auction interest is weak.

- Arguably, dealers do not buy the Treasury's auctions out of goodwill to the Treasury. They buy them because they can profit from them. They can profit from them because, compared to other market investors, they have sole access to superior market information. This more complete market information translates into better auction information as well. How is this in the public interest?

- The real underwriters of Treasury auctions are the final users, the investors. If these final users had access to the same information as the primary dealers, there would be no need to bid for auctions through and with the dealers.

JAN 29 1987

The dealer's contention that they underwrite, or are responsible for the success of Treasury auctions, is not true. Final users are responsible for successfully underwriting auctions.

- Primary dealers will make a market in any Treasury security. That market will reflect a host of factors. Among them will be the age and size of the issue, whether or not the issue has been stripped, and how close the coupon is to current coupons. The most important factor, however, is whether or not the dealer is involved in the issue or is in contact with a market participant who is. The best price, either bid or offer, will always be made by the most interested party, i.e., the party with the necessary position to do the trade.

- The primary dealers insinuate that they, because of their commitment to the market, stand ready to be the most interested party. Sometimes they are. Most of the time they are not. Primary dealers are simply the funnel for most market activity and information.

- An example would be helpful. Suppose an investor calls a primary dealer and asks for a market on a particular Treasury security. If the dealer has no position in that security (this is usually the case) and is not working a position for a customer in the issue, the dealer will look to the primary broker screens. Suppose that the issue shows up on the screens at 100 2/32-4/32. The dealer could therefore make a market to the customer of 100 1/32-5/32. If the customer buys the issue at 100 5/32, the dealer can lift the offering in the screens at 100 4/32 and profit. If the customer sells the issue at 100 1/32, the dealer can, in turn, sell it at 100 2/32 and profit. Ultimately, <u>someone</u> had a better market for the issue. That someone was either another primary dealer <u>or</u> a customer working an order through a primary dealer (the most likely case). How is the public interest served by mandating more than one market maker in this case? In other words, why shouldn't the customer have access to the best market; that market made by the most interested party?

JAN 2 8 1987

- The primary dealers act as a funnel for bids and offerings on securities for the Federal Reserve when the Federal Reserve wants to executes monetary policy. Sometimes the primary dealers bid or offer for their own account. However, for the most part they reflect customer bids or offers. In many instances they charge customers for showing their bids or offers. In all cases, the primary dealers garner information on the ownership and distribution of securities that is not available to all market participants.

- Therefore, monetary policy is not conducted strictly through the primary dealers. Monetary policy is effected mainly through the positions of the primary dealers' customers. For the most part, the dealers are merely the conduit. The primary dealers' role as a conduit may aid the Federal Reserve. However, to argue that fair and just compensation for this service is restricted access brokerage screens sounds ridiculous and hardly in the public interest.

Addressing the Trading Access-Broker's General Concerns

- The primary dealers' contention that only trading on a blind basis will reduce risk is a hollow argument, since all that needs to be established are standards of credit worthiness and a mechanism for monitoring them. Secondly, regional dealerships, insurance companies, and large pension funds who would be the most likely new users of broker screens, already deal with the primary dealer community and in fact are their best customers.

- The large non-primary dealer institutions such as regional banks, insurance companies, and pension funds are perfectly capable of processing transactions on time and avoiding fails. Currently, primary dealers require customers to deliver securities to them (i.e., primary dealers) with an earlier cut-off time than they require from other primary dealers. However, the same time limit does not apply to the primary dealers delivering to customers.(ie., regional brokers, insurance, or pension funds). Fails rarely occur due to a "real money," (i.e., pension fund or insurance company), customer's failure to deliver. Rather, fails occur due to the primary dealer's short selling and their collective inability to borrow the shorted securities in order to fulfill delivery of their sales.

JAN 2 8 1987

Agreeing on proper minimum creditworthiness standards would solve this potential problem. Again, 99% of the primary dealers now deal with 99% of the non-primary dealer institutions who would utilize interdealer brokers.

- "Oversight and monitoring provided to primary and aspiring primary dealers by the Federal Reserve" is no argument at all for restricting access to broker screens, since the Federal Reserve does not implement monetary policy through broker screens but rather by calling the primary dealers directly.

- Service quality is a new issue. However, the service quality of Cantor Fitzgerald, the "retail" broker, is very high despite having 200+ customers.

- The issue of volume should not be the sole determing factor in allowing screen viewing and access. A monthly fee could be charged to those customers who do not meet the broker's minimum required volume.

Mortgage-Backed Market

- There is currently no screen in existence for Mortgage-Backed Securities (MBS), not even a retail screen.

- MBS represent a large and fast growing market segment. Yet no price information is publicly available.

- The agency MBS areas are created to provide easier access for public funds to the housing market. Therefore, on the one hand it is public policy to provide product standardization and subsidize this market (through the MBS agencies, tax incentives, etc.). Yet, on the other hand public policy does not address efficiency in the secondary markets for this important sector of the US economy. When the Fed (New York) consides a new application for Primary Dealer status, one major area of consideration is wide distribution (ie. bank portfolios, insurance portfolios, money manager portfolios, etc.). Yet, these end-users are not able to deal directly. This leads to inefficiency for the end-users, since they cannot match prices directly in the open market.

JAN 2 3 1987

APPENDIX IV

COMMENTS SUBMITTED BY
THE ASSOCIATION OF SCHOOL
BUSINESS OFFICIALS, INTERNATIONAL

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TESTIMONY PREPARED FOR

February 4, 1987 - General Accounting Office Public Hearing

Re - Nature of the Current Trading System in the Secondary Market for U.S. Government Securities.

Presenter: Bruce Brummitt, Executive Director, New York State Association of School Business Officials, representing the Association of School Business Officials International: Reston, Virginia.

Background of the Presenter and reference sources used to prepare this testimony: see Appendix 1.

I have titled my remarks "Swimming in a Pool of Sharks" because it describes the feeling that most local governmental officials share when they are involved with the Secondary Dealers Market.

I've always liked sharks, even enjoy eating sharks, but I never realized how dangerous our association might become.

I've been in a pool swimming with secondary dealers for almost 15 years. At one time, I bought and sold treasury bills on a weekly basis through a primary dealer.

During the first 10 years, I was unaware of the existence of predators in the marketplace. Along with many New Yorkers, I learned some powerful lessons during our 1984-1985 market experience with secondary dealers.

At this point, I will begin to respond more specifically to the three topics for discussion at this hearing listed in Federal Register of January 2, 1987.

I will group similar answers to multiple questions within each topic for consideration of time, clarity and brevity.

Topic 1 Trading Access (11 Questions)

Responses to Questions 1, 2, 3, 4

3. State governments are beginning to recommend and may eventually require an independent third party holding of securities which are used as collateral (usually Fed paper). This complication is increasingly restricting the market for federal securities partially because banks are reluctant to do business on this basis.

It would appear appropriate at this point to make the remark that most of us who testify today must feel like the dummy partner in a bridge game.

You, especially the Treasury and Federal Reserve representatives present, are holding cards that we have not seen. We do not know what regulations or changes are in the process.

Hopefully, this testimony will filter through to those who will promulgate the rules. I'm not all certain that much of this testimony will be relevant or meaningful when those cards are played and the directives issued.

However, this is the only game in town for us at this point.

The constituency that I hope I represent has lost a great deal of confidence in the safety of the current marketing system.

We are beginning to realize that you consider us to be competitors for the investors' dollar while we continue to believe that, in fact, we are one of your major investor groups (in federal securities).

We do not believe that the marketing process is as safe as it should be unless in order to:

1. Protect the public interest.
2. Safeguard the investment of public funds (below the federal level).

How can the investor know whether he has really bought Federal paper and at a fair market price? The dealer is a fiduciary in securities at little risk for his possible acts of fraud or misfeasance. The SEC is the Registry of Securities' Dealers with power over all those who register to sell securities.

We do not believe that the marketing process is as safe as it should be unless in order to:

1. Protect the public interest.
2. Safeguard the investment of public funds (below the federal level).

Response to Question 6

Question 6 is in fact 6 questions rolled into one. To us, the primary issue is an old one, " Will regulation, i.e. restricting of the number of dealers or regulating the sale, settlement and transfer of funds, negatively affect the marketing of your securities?"

We believe that the real problem concerns the credibility of the marketing system which we believe is currently at question. Most investors tend to believe that the federal government regulates those who sell Federal paper.

They believe that the Securities and Exchange Commission protects the investor against fraud and that violators are prosecuted or prevented from further activity in the marketplace.

If the investor really understood how the system works, he would invest a greater amount of money in the private sector than in federal paper.

This is a need for immediate regulation and vigorous prosecution of fraud or surely funds will increasingly drain to an already vigorous stock market.

There is a new advent which should be considered.

New public investment structures are being developed - 5 states have some form of investment trust which pool the monies available for investment. The result may reduce the need for large numbers of security dealers.

"We would recommend complete access of market information to all who seek it."

The sale of this information (dissemination) should pay for itself and should not be a cost to the federal government.

Response to Qeustion 9

Yes! Whether a dealer is an agent or a principal revolves around the question of accountability. As an investor I really don't care what the dealer is called, but he must be fully accountable for any fraudulent acts. Where possible, the investor should be "saved harmless" and have a primary protected interest (guaranteed ownership) of the securities from the point of payment on.

Response to Question 10

I am not knowledgeable to comment.

Response to Question 11

I would be most willing to respond if I knew what the FRS is considering.

Topic 2 Access to Quotation Information

Response to Questions 1 & 2

We find it difficult to understand why the information should not be available to anyone who has an interest. Such information has commercial value and should add no additional federal cost to the marketing of securities.

There is a real question in our minds as to whether the present system provides a favored position to those who are clients of blind brokering. In fact, there may be an insiders' issue involved.

Response to Question 3

I am not qualified to respond. However, I would tend to believe that the answer is yes.

Response to Question 4

Obviously there is an advantage or this hearing would be unnecessary. It should be eliminated in order to improve the public confidence in the market and to protect the general interest of the public.

Response to Question 5

I am not qualified to respond. It is my belief that more information would be helpful and should add positively to public confidence in the marketplace.

Topic 3 Utility of Brokering Service and Quotation Practices

Response to Question 1

In the past there was a great deal of trust placed in the security dealer. That trust has been replaced with an uneasiness on the part of the public investor. He has been cautioned by state office to deal only with primary dealers. The more he learns about the market, the less he wants to use it.

The fear and reluctance are still there because of the 1984-1985 market frauds and failures and many former public investors have left the marketplace.

Response to Question 2

The best route to clearing up any practice is to monitor, audit and prosecute those who work against the public interest and impair the credibility of our federal monetary system.

Response to Question 3

I am not sure that I am qualified to respond, but my understanding of how the securities and exchange commission regulates, monitors and pursues fraud in the marketing of private securities (with the cooperation of treasury, the federal reserve system and the attorney general's office) leads me to believe that we know how to regulate the marketplace, but we are reluctant (all of us federal, state, and local issuers of securities) to raise a hand or offer a shout which might upset "the goose that lays the golden eggs". (the goose, of course, is security dealer)

I, and those I believe I represent, sincerely appreciate the opportunity to offer testimony and would commend the Federal Reserve, Treasury, SEC, and GOA for the manner in which these issues were presented and opinions solicited.

Needless to say but important nevertheless is the fact that we would appreciate future opportunities to respond to suggestions for improvement of the federal securities marketplace.

For the Association of School Business Officials International

Bruce Brummitt
Executive Director,
New York State Association
of School Business
Officials

APPENDIX 1

References used for Background Analysis:

1. U.S. Treasury Securities: "The Market's Structure", Risks and Regulation, August 20, 1986. (Requested - but not received as of February 2, 1987.)
2. Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements. April 1986 Statement No. 3 of the Governmental Accounting Standards Board.
3. Regulation of the Government Securities Market. Report by the Securities and Exchange Commission, June 20, 1985.
4. Capital Adequacy Guideline for U.S. Government Securities Dealers. Federal Reserve Bank of New York, May 20, 1986.
5. Transcript of May 15, 1985 Hearing on Fraud in the Marketplace of the Subcommittee on commerce consumer and monetary affairs of the House Committee on Government Operations.
6. "Gambling with Public Funds", the Lion Capital Bankruptcy and Its Implications for Government Investment Practices. New York Assembly, committee on Ways and Means. March 1985.
7. Cash Management and Investment Policies and Procedures for use by local Government Officials. Office of the State Comptroller, Albany, NY. December 1984.

8. Survey of the Federal Reserve's System Supervision of the Treasury's Security Market. U.S. General Accounting Office. October 1984.

APPENDIX 2

Related Background of the Presenter, Bruce Brummitt:

- Task Force Member - Governmental Accounting Standards Board Statement No.3. See item 2 above.
- Responsible for investment of School District funds for 27 years.
- Past 7 years as Executive Director of New York State Association of School Business Officials.
- Presenter at 20 plus workshops on Cash Management presented at state and national conferences of School Business Officials and School Board Members 1982-86.
- Author of a dozen or more periodical articles on the Security Market in state and national publications.
- Drafted ASBO International position paper on October 1984 GOA Study. (8 above).
- Adjunct professor of Educational Finance, Saint Rose College, Albany, NY and State University of NY at Plattsburgh.
- Consultant, NYS School Boards Association, re Treasury Department Regulations, Federal Securities Market, Cash Management 1983-present.

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APPENDIX V

COMMENTS SUBMITTED BY
GOLDMAN SACHS AND COMPANY

Goldman, Sachs & Co. | 85 Broad Street | New York New York 10004
Tel: 212-902-5740

Gail S. Berney
Assistant General Counsel

Goldman Sachs

January 30, 1987

Craig A. Simmons
Senior Associate Director
General Government Division
United States General Accounting Office
441 G Street, N.W., Room 3862
Washington, D.C. 20548

Re: Request for Comments on Quotations for Government Securities - File No. 233175

Dear Mr. Simmons:

Attached to this letter is a comment letter prepared by Jon Corzine of this Firm responding to the request he received from you dated January 8, 1987. I spoke to your associate, Paul Zacharias on January 23 and we had agreed at that time that we would be able to submit our comment letter by the end of this week.

In order to get this to you as quickly as possible, I have sent a copy by rapifax to our Washington D.C. office for forwarding to you today. A hard copy of the letter will follow on Monday.

If you have any questions regarding our comments, or would like to discuss them further, please do not hesitate to call me.

Yours sincerely,

Gail S. Berney

Enclosure

cc: Jon S. Corzine

JAN 30 1987

Goldman, Sachs & Co. | 85 Broad Street | New York, New York 10004
Tel: 212-902-8281—212-902-8340

Jon S. Corzine
Partner
U.S. Government Trading

Goldman Sachs

January 30, 1987

Mr. Craig A. Simmons
Senior Associate Director
General Government Division
United States General Accounting Office
441 G Street, N.W., Rcom 3862
Washington, D.C. 20548

Re: Request for Comments on Quotations for Government Securities - File No. 233175

Dear Mr. Simmons:

We appreciate this opportunity to respond to the questions you forwarded to me on January 8, 1987. In that letter you requested this Firm's comments on the questions posed by the GAO in connection with its study of government securities brokers' activities and, in particular, the use of the blind brokering screens. These questions appeared in the January 2 Federal Register.

Goldman, Sachs & Co. is a registered broker/dealer, as well as one of the FRBNY's forty reporting dealers. In addition to being a dealer in government and agency securities, the Firm is a market maker in corporate debt and equity and municipal securities. The Firm serves a broad range of clients, a large portion of which are institutional clients, including governments, corporations and financial institutions, as well as certain high-net-worth individuals. Goldman Sachs is subject to the regulatory oversight of the Securities and Exchange Commission, the Federal Reserve Bank of New York, the Commodities Futures Trading Commission and several foreign regulatory bodies. In addition, Goldman Sachs is a member of a number of self-regulatory bodies, including the NASD, the MSRB, the NFA and all the major domestic stock and futures exchanges.

Before commenting on the specific questions raised by the GAO, we would like to explain how we evaluate, and how we use, the blind brokering system. Goldman Sachs relies heavily on the blind brokering systems in connection with its government trading activities. Its importance to our Firm rests in part on the confidentiality it provides the

traders that utilize the system. But these benefits and, as a result, the viability of these systems are primarily dependent on the creditworthiness of the participants in these systems. (We use the term "creditworthiness" to encompass not only the capital and resources of the participants, but also the controls and other prudent management techniques they employ.) The brokering systems function efficiently and provide substantial liquidity to the government securities market <u>because</u> participants are able to make trading decisions without focusing unduly on the financial stability and quality of their counterparty. Without this comfort, the efficiency of the government markets and the added liquidity currently afforded by such systems would be severely undermined. It is, therefore, our view that both the informational and trading functions of these blind brokering systems provide a depth to the government securities markets, which in turn is reflected in a lower cost of financing to the Treasury.

While we are not in a position to provide detailed responses to all of the questions posed by the GAO in the January 2 release, we have addressed certain questions in each of the three areas covered in the hope that we might provide useful information in connection with your review of this important issue. For your convenience, the numbers preceding our responses correspond to the numbers used in the January 2 release.

<u>TRADING ACCESS</u>

1. As discussed above, the blind brokering system is extremely important to the efficient functioning of the government securities market. Goldman Sachs' cash flow approximates $30 billion daily. An overwhelming proportion of this total results from our participation in the government securities market. Our potential credit exposure is enormous. If we were to develop doubts about the creditworthiness of any single member of the system, it would have severe ramifications on our willingness to trade actively.

2. The primary benefits rendered from the blind brokering system as currently structured are the confidentiality of the trades and the comfort afforded by the assurance of the creditworthiness of the participants and the

Goldman Sachs

systems as a whole. Alternative arrangements could extend the informational data to a far wider universe of participants. Similarly, the trading privileges could be expanded, but only as long as high credit standards, coupled with appropriate monitoring of management procedures, are maintained.

3. The paramount concern is the creditworthiness of the participants.

4. As discussed above, the fact that the standards set bolster the confidence of the participants in the viability of the system is an important factor that improves the liquidity and efficiency of the market. While we cannot speak for all government securities market participants, we believe that our clients generally have access to a wealth of information regarding market movements, which often includes the information they would otherwise obtain by having access to these brokering screens. Primary dealers regularly provide price information to their customers. In addition, customers may directly obtain access to the Telerate system, which provides parallel information.

6. The relationship with the FRBNY is a factor that is extremely important because of the credit standards set by the FRBNY and its monitoring of the activities of the reporting dealers. As a primary dealer we have great confidence in the surveillance methods and the supervisory role undertaken by the FRBNY. The primary dealers must report inventory positions on a daily basis to the FRBNY and are subject to spot checks. These activities afford us great comfort in the blind brokering system as well, because we are assured that the participants have adequate capital and resources and are engaging in prudent business activities and exercising management controls. Moreover, we believe that the confidence of the participants in the systems is bolstered in part by the reliance placed on these systems by the Federal Reserve and the Treasury.

7. As long as high credit and management control criteria are met, we do not believe there would be any major adverse consequences. If the creditworthiness of the additional participants is, however, in any way compromised, such an extension would severely and adversely impact market liquidity. One obvious side effect would be to affect

JAN 3 0 1987

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adversely the Treasury's ability to raise funds efficiently and cheaply.

8. We believe that the concerns noted in our response to item 7 are equally relevant if partial access to the system is given to firms that specialize in limited areas of government securities activities. But this would mean that the high credit and management control criteria referred to above must extend to all areas of such firms' operations and not just to their areas of specialization within the government securities markets.

9. We are confident that the rules adopted by the Treasury Department will be able to serve as a basis of measurement when evaluating whether an institution is sufficiently creditworthy to be given access to these systems. We would caution, however, that merely satisfying the minimum standards that may be set by the Treasury should not in and of itself be sufficient to warrant such access.

ACCESS TO QUOTATION INFORMATION

1-4. In our opinion, the information contained on the blind brokering screens could be made available to any broker/dealer or customer that seeks it. It is our understanding that a large portion of the information that appears on such screens is promptly and widely disseminated in some form to active market participants who may not currently have direct access.

5. The data collected and published by the Federal Reserve is extremely useful for a variety of purposes. It is not, however, a substitute for the information obtained from the brokering screens.

UTILITY OF BROKERING SERVICES AND QUOTATION PRACTICES

1. We believe that our customers evaluate us as a dealer on the basis of a variety of factors, the most important of which are the price at which we are able to execute their orders and the efficiency with which we do so, our clearing capabilities, the services (including research) we are able to provide, and our own creditworthiness. In many instances the last criterion may be of dominant significance.

Goldman Sachs

We are pleased to have had this opportunity to be able to respond to the questions you have raised.

Yours sincerely,

Jon S. Corzine

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COMMENTS SUBMITTED BY THE GOVERNMENT SECURITIES BROKERS ASSOCIATION

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COMMENTS OF THE

GOVERNMENT SECURITIES BROKERS ASSOCIATION

TO THE GENERAL ACCOUNTING OFFICE

CONCERNING

THE NATURE OF THE CURRENT TRADING SYSTEM

IN THE SECONDARY MARKET FOR U.S. GOVERNMENT SECURITIES

JANUARY 23, 1987

FILE NO. 233175

President
Richard G. Jackson
RMJ Securities Corp.
Vice President
Thomas J. O'Keefe
Garban Ltd.
Secretary
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Government Securities Brokers Association

January 23, 1987

Via Hand Delivery

Mr. Craig A. Simmons
Senior Associate Director
General Government Division
General Accounting Office
Room 3862
441 G Street, N.W.
Washington, D.C. 20548

Re: GAO Request for Comment on the Nature of the Current Trading System in the Secondary Market for U.S. Government Securities File No. 233175

Dear Mr. Simmons:

This letter is to provide the General Accounting Office ("GAO") with comments from the Government Securities Brokers Association ("GSBA")[1] pursuant to the request for comments appearing at 52 Fed. Reg. 220 et seq. January 2, 1987. Our comments concern the nature of the current trading system in the secondary market for U.S. government securities.

It must be emphasized that the decision to limit or

1/ The GSBA is a national trade organization representing U.S. government securities blind brokers. The Association was formed in April, 1986 by a group of U.S. government securities brokers as a forum for the discussion of issues central to the efficient functioning of the government securities industry. Primary among its activities is the presentation of the views of the government brokers to governmental regulators and to the financial community for the purpose of insuring the continued liquidity and efficiency of the U.S. government securities market. The GSBA members are Cantor Fitzgerald Securities Corp., Chapdelaine & Company Government Securities Inc., Fundamental Brokers, Garban Ltd., Liberty Brokerage Inc., MKI Government Brokers, Inc., and RMJ Securities Corp. Today, the membership collectively accounts for over ninety percent of the transactions effectuated through government securities brokers.

President
Richard G. Jackson
RMJ Securities Corp.
Vice President
Thomas J. O'Keefe
Garban Ltd.
Secretary
Edward J. Gerig
Fundamental Brokers
Treasurer
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to broaden trading and information access to a broker's screen is an individual decision made by each firm based upon its business judgment. Because many of the questions presented for comments raise important commercial and competitive issues that can only be properly addressed by a broker individually and not by an association, the GSBA's responses are designed not to provide a definitive answer to a particular question but rather to set forth the issues that industry members recognize as being significant factors affecting their individual determinations of the issues under consideration. In short, the following comments represent a composite of the full range of views within the membership of the GSBA and do not necessarily represent the specific views of any single government securities blind broker.

The government securities market -- including the obligations of the United States, its agencies, and related entities -- is recognized as the cornerstone of the U.S. capital market system which has profound effects on the interrelated world economy and international securities markets. The complexity of this market and the need for thoughtful, considered study of the issues relating to its regulation has only increased with its tremendous growth within the past decade.

JAN 27 1987

As the world's largest, most efficient, and liquid securities market, typically, more than one hundred billion dollars' worth of U.S. government securities is traded in a single day. In 1985, the Treasury raised a total of almost $1.2 trillion from the auction market in government securities, to finance the budget deficit and to refinance maturing debt.2/ The market's direction is toward continued increase in trading volume to accommodate the future growth of Government debt, which is estimated, under current policy to reach $2.5 trillion by the end of fiscal 1989.

The passage last year of the Government Securities Act of 1986 (the "Act"), has brought into sharp focus the significance of the U.S. government securities market to the functioning of the government and to the entire U.S. economy. It is a matter of concern to all market participants that issues affecting the U.S. government securities market be carefully considered and acted upon with measured restraint in order not to impair the efficient operation of the market, increase the costs of financing the Federal debt, or compromise the execution of domestic monetary policy.

2/ "Report on U.S. Treasury Securities -- The Market's Structure, Risks and Regulations", briefing prepared by the U.S. General Accounting Office to the Chairman, Subcommittee on Domestic Monetary Policy, Committee on Banking, Financing and Urban Affairs, House of Representatives, 99th Cong. 2d Sess., Aug. 1986, p. 20.

JAN 27 1987

It is clear that of paramount importance to Congress in passing the Act was to provide for regulations and procedures that facilitate and maintain the liquidity and depth of the U.S. government securities markets. In Section 1(b)(1) of the Act, it is stated that "The Congress finds that transactions in government securities are affected with a public interest which makes it necessary to provide for the integrity, stability, and efficiency of such transactions and of matters and practices related thereto."

Government securities brokers fall into two categories: interdealer brokers and "retail" brokers. Today, interdealer brokers provide their services to approximately 53 primary and aspiring dealers recognized by the Federal Reserve Bank of New York. Retail brokers provide quotation and trading access to a broader market, based on the individual broker's determination of the creditworthiness of the market participant.

Today, the members of the GSBA are responsible for effectuating approximately 50 percent of the $100 billion in government securities traded daily by the primary and aspiring dealers. Government securities blind brokers do not purchase or sell U.S. government securities, but rather display and then match the bids and offers placed with them by the dealers. Transactions effected through these brokers, are

JAN 27 1987

handled anonymously, without revealing the identity of the buyer or the seller of a particular trade.

Major securities dealers frequently execute a trade through a broker rather than trading directly with another dealer in order not to reveal their trading strategies. This orderly and anonymous handling of a large trading volume facilitates market liquidity and depth and has resulted in the ever increasing importance of brokers as an integral part of the government securities market.

The GSBA strongly believes that when considering any mandated changes to the existing framework for effectuating government securities transactions that prudence and caution will best serve the interests of all market participants as well as the U.S. Government.

It is our hope that the following responses will assist the GAO in its examination of the complex issues involved in analyzing whether any changes should be made to the current scope of access to brokers' trade information and the brokering system.

A. QUESTIONS REGARDING TRADING ACCESS

A1. How important is blind brokering for the efficiency and liquidity of the government securities market?

JAN 27 1987

The GSBA believes that blind brokering is essential to ensure the continued efficiency and liquidity of the government securities market. The U.S. government securities market is recognized as the largest, most efficient, and most liquid securities market in the world. It is the belief of the GSBA members that the practice of blind brokering has enabled the market to operate smoothly and efficiently. If the system of trading anonymously in this market were altered, the speed of the transactions and, therefore, the market's liquidity would be impaired.

The speed and the confidentiality afforded by the blind brokering system has allowed each participant in the market to effectuate its own trading strategy without revealing its position to competitors. If trading in the government securities market were not anonymous, it is likely that the prices, the sizes of the blocks of securities traded, and the volume that each dealer traded would be negatively affected. This reduced volume of trading would create higher transaction costs and could produce greater price volatility which together could impair market efficiency and liquidity.

A2. What are the costs and benefits of the current system of limited access blind brokering? What alternative

JAN 27 1987

arrangements, if any, should be considered? How does their costs and benefits compare with those of the existing system?

The principal benefits of current limited access blind brokering relate to the integrity of the market. First, the rationale for limited access blind brokering has developed as a result of the desire of market participants to ensure the creditworthiness of their counterparties to a government securities transaction. Thus, the fact of limited access has been perceived by customers of brokers to ensure this need for financial responsibility on behalf of those utilizing the blind brokering trading system.

Second, dealers have repeatedly stated that the limiting of access to only the most creditworthy of market participants has contributed to their willingness to assume market-making responsibility. It must be taken into consideration that changes in access to the blind broker system could result in changes in dealers' willingness to assume this market-making function.

With respect to the question of what alternative arrangements to the current limited access system should be considered, it is difficult to assess the potential consequences of any such alternative. Obviously, an alternative to the existing system is one which permits access

JAN 27 1987

to all creditworthy dealers. If, however, this resulted in current market participants reducing their utilization of the services of blind brokers, this could increase trading inefficiencies and price volatility.

Any alternative to the existing system which would have the effect of reducing the volume of government securities traded through blind brokers would most likely have the effect of increasing the cost of issuing and selling the government's debt instruments. Thus, great caution should be exercised when considering any mandated changes to the existing system.

The GSBA is aware that changes to the existing system involving varying degrees of increased access and methods for ensuring creditworthiness can be conceived. However, given the lack of historical data, the Association cannot offer an opinion as to whether any of these alternatives would benefit or impair the functioning of the blind brokering system. When contemplating any changes to the existing system, the Association strongly believes it essential to consider the impact that such a change may have on the costs associated with a government security transaction effectuated through the interdealer brokers. For example, the costs of performing interdealer brokering activities may be increased because a broker would have to develop separate credit monitoring

JAN 27 1987

capability and would likely be subjected to increased capital requirements necessary to assume greater credit responsibility for market participants utilizing the brokers' services -- risks that interdealer brokers do not have today.

A3. Of the considerations influencing screen broker decisions on which firms should have access, which do you feel are relied on most heavily and which least heavily? Is this appropriate? Please explain.

In making the decision regarding to whom the broker will provide access, a government securities blind broker typically considers the following issues:

(i) **Financial stability of a prospective customer.**

It is extremely important to brokers and dealers that all market participants utilizing the blind brokering system be financially responsible.

In an effort to assure financial reliability, brokers and dealers have historically relied

JAN 27 1987

upon the fact that a market participant is subject to the oversight and monitoring activities of the Federal Reserve Bank of New York ("FRBNY").

(ii) Trading qualifications of prospective customers.

The trading qualifications of prospective customers' personnel is also taken into account in determining whether the staff of the prospective customer is knowledgeable, trustworthy, and able to trade with a high degree of competence and integrity.

(iii) The volume of trading activity of a prospective customer.

Brokers also consider the extent to which a prospective customer is an active participant in the government securities market. The volume and frequency of a customer's involvement in the market impacts a broker's overhead and transaction costs as they relate to servicing the customer's account.

JAN 27 1987

Of the aforementioned factors, brokers most heavily rely on whether a prospective customer will be perceived as sufficiently reliable and financially responsible so as not to damage confidence in the blind brokering system.

A4. What are the consequences of current access practices for the liquidity and efficiency of the market and for various market participants? In your answer, please distinguish carefully between types of dealers and investors.

For the most part, the current system functions extremely well and represents a safe and efficient mechanism to accomplish speedy and confidential government securities transactions. However, this is not to suggest that limited changes which are well conceived and implemented incrementally may not result in marginal increases in liquidity and in market efficiency. The GSBA, however, cannot now recommend any change to the existing system due to the unavailability of historical data from which to evaluate intelligently the impact of such a change.

For example, if expanding market access resulted in primary and aspiring dealers having less confidence in the financial integrity of the blind brokering system, they may

JAN 27 1987

forego utilizing these brokers. This would diminish greatly the utility of the blind broker, thereby increasing inefficiency, adding transaction costs that otherwise would not have existed, and impairing the liquidity of the market.

On the other hand, if a mechanism were devised whereby customers with trading access to broker screens were sufficiently creditworthy, this could work to eliminate concerns by others that utilizing a blind brokering system would present undue risk. Expanding the number of participants in the system, while maintaining efficient markets, would likely increase the depth of the market in each government issue and reduce the price spread on such issues. This would decrease price volatility, enhance investor confidence, and improve the ability of the government to fund its debt.

A5. What risks are associated with blind brokering? Who bears these risks? Do the risks necessarily increase when the numbers of dealers trading on the system increases? What alternatives exist to control these risks? Which, if any, of these alternatives provides an acceptable level of risk control at a reasonable cost?

JAN 27 1987

Three areas of risk are associated with the blind brokering system of trading U.S. government securities.

(i) Misunderstandings in price, issue, or quantity.

Executing a government security transaction through the blind broker system involves telephone communications between the broker and its customer. There is always the possibility of misunderstandings concerning the price, issue, or quantity involved in the transaction. Generally, these differences are resolved quickly through direct discussions between the involved parties.

(ii) Expenses associated with financing failed transactions.

On occasion, a broker will receive securities that because of the closing of the Fedwire, it is unable to deliver to its customer. When this occurs the broker must finance the purchase price of the securities overnight until it is able to effectuate the delivery to its customer.

JAN 27 1987

Historically, the aggregate expense incurred by all brokers on an annual basis is extremely small when compared to the volume of the securities they are responsible for trading during the same period. In addition to the fact that these occurrences are infrequent, this risk is further minimized by the fact that the expense incurred is sometimes the subject of negotiations between the broker and the dealer that was responsible for the failed transaction.

The Association and its members believe that the risk of fails can be considerably reduced if the FRBNY would automatically extended the Fedwire closing time whenever a large number of transactions have not been completed within 15 minutes of the standard 2:30 p.m. closing time, or alternatively provided brokers with a brief fixed turnaround time to finalize deliveries. They further believe that regulations requiring dealers and clearing banks to accept partial deliveries or the implementation of the maximum

JAN 27 1987

delivery size proposed by the FRBNY would facilitate a reduction in the market backlog of transactions that must be completed in the short period of time just prior to the Fedwire closing time.

(iii) <u>The risk of assuming exposure as a principal as opposed to an agent.</u>

In the current system of blind brokering, the non-retail brokers act as agents on behalf of unidentified principals and do not assume the financial responsibility that a principal bears if a transaction fails. If there were a substantial increase in the number and nature of dealers and investors granted access to interdealer screens, it could lead to increased costs to brokers as a consequence of having to develop credit monitoring capability and having to maintain increased capital requirements necessary to assume the credit responsibility for the expanded base of market participants utilizing the brokers' screens.

JAN 27 1987

A6. For what reasons do you consider it acceptable or unacceptable for brokers to require new customers to first have a business relationship with the FRBNY as a primary dealer before it will consider the customer's application for access? To what extent, if any, does your answer depend on your perceptions of the FRBNY's business relationship with primary dealers? If it does, what aspects of that relationship are most important?

The GSBA believes that it is acceptable for brokers to rely upon the reporting relationship of a customer to the FRBNY because today, unlike the equity or other markets, no common or uniform methods for evaluating the financial stability of a participant exists in the government securities market. The one measure of financial responsibility that has historically proved trustworthy is the designation by the FRBNY that a market participant is a primary or aspiring dealer.

To a great extent brokers' reliance upon the FRBNY's designation as a surrogate for creditworthiness is a consequence of the understanding that the FRBNY monitors the financial reliability and adequacy of these dealers on a regular basis. Another important basis for such reliance is

JAN 27 1987

that the customers of the brokers have indicated a satisfaction with the use of the FRBNY designation as indicating creditworthiness and thus providing them with the comfort that market participants are financially responsible.

Under the Government Securities Act of 1986, all dealers and brokers in U.S. government securities would be registered and capital adequacy requirements would be established. It is possible that the registration and the minimum capital adequacy requirements may be viewed as an adequate substitute for designation by the FRBNY as a primary or aspiring dealer as a determination of sufficient creditworthiness and financial responsibility.

It must be kept in mind that the standards of creditworthiness and financial reliability that any broker utilizes is a matter of individual choice and is a function of a broker's unilateral exercise of its business judgment.

A7. What would be the consequences if the list of dealers with trading access to interdealer screen brokers were to diverge significantly from the list of primary or aspiring primary dealers? Would brokers allowing expanded access lose business? If they did, would the loss of major market participants from the screen brokering system make it harder

JAN 27 '87

to sell the public debt or to conduct monetary policy? Would risks in the interdealer market increase significantly? To what extent might any cost of allowing such access be offset by any benefits from greater participation by other dealers in these systems?

If trading access to interdealer broker screens were to increase significantly, the following consequences are possible:

(i) The brokers could experience higher costs of doing business as a result of increased equipment and personnel expense that would be required to transact business with an expanded customer base. These costs would have to be justified to warrant the willingness of brokers to expand access to accommodate the larger customer base.

(ii) Expanding access to brokers' screens to a greater and more diverse group of participants could result in enhanced competition, which would have the effect of narrowing quotation spreads and adding to the depth and liquidity of the market.

JAN 27 1987

(iii) Expanded access to participants who were perceived by existing market participants as adding uncertainty and increased financial risks to transactions involving blind brokering could result in a weakening of competition and an impairment of market performance. This would occur if the existing participants greatly reduced or withdrew from their utilization of the blind brokering system. This concern would be enhanced if expanded access increased the perception by existing market participants that brokers were no longer unbiased but rather were actual or potential competitors.

(iv) Expanded access may also have the effect of altering the current responsibility of a broker because it may result in a broker having to assume the credit risk associated with the failure of a party to a transaction - a risk an inter-dealer broker does not now have. This would likely increase transaction costs and threaten the continued viability of the blind brokering system.

JAN 27 1987

A8. Under what conditions, if any, should firms who are neither primary nor aspiring primary dealers but who specialize in certain segments of the Treasury, agency, or mortgage-backed securities markets be able to obtain trading access to the interdealer broker screens for segments of the market in which they specialize? Would greater availability of limited access arrangements for such dealers affect the overall depth and liquidity of these markets? Please explain.

If a dealer specializing in a segment of the market is financially sound, is an active market participant, trades with competence and integrity, and meets standards of creditworthiness and financial reliability necessary to inspire confidence by other participants, then it is likely that the addition of these specialized dealers would create greater depth and add liquidity to these specialized market segments.

A9. The Treasury Department must adopt rules for brokers and dealers, including rules for financial responsibility. Would you expect these rules, and the associated enforcement of them by the appropriate federal regulator, to affect access to interdealer broker trading systems? In answering these

JAN 27 1987

questions, what assumptions have you made about whether interdealer brokers are acting as agent or principal?

It is not possible at this juncture to assess what relationship, if any, will develop between the capital adequacy rules for brokers and dealers that the Treasury Department promulgates and the issue of expanded access to the interdealer broker trading system. As mentioned above in responding to previous questions, capital adequacy is but one consideration that each broker would review in making its unilateral decision to enter into a business relationship with a prospective customer.

In answering this question, the GSBA has assumed that the brokers act exclusively as agents on behalf of unidentified principals, who are regulated government dealers that purchase and sell government securities.

A10. Would development of a netting system for clearing and settling government security trades affect the risks faced by screen brokers and their customers? How, if at all, would you expect such developments to affect access to interdealer broker trading systems?

JAN 27 1987

A properly designed and implemented netting system should reduce the risks in the settlement process for government securities for both the dealer and the broker. It would, for example, likely reduce the number of fails at the end of the trading day, and likely reduce the amount of traffic on the Fedwire.

However, any proposed netting system should incorporate requirements for the following: the mandatory submission of all trades, the establishment of a properly calculated participants fund, and the development of a proper basis for calculating any transaction adjustment payments.

Without the inclusion of the foregoing, a netting system could increase rather than decrease the brokers' and dealers' exposure to risk.

The creation of a proper netting system could affect access to broker screens because it could provide another viable credit monitoring device that could be relied upon by market participants.

All. How might actions designed to reduce daylight overdraft exposure now being considered by the Federal Reserve System affect your assessment of the blind brokering system and access to it?

JAN 27 1987

The Fed action regarding a reduction in daylight overdraft exposure will not affect the blind brokering system or access to it. However, significant restrictions placed upon clearing banks or the imposition of stringent time and volume limitation on the transfer of book entry securities would adversely affect brokers as well as other market participants.

B. QUESTIONS RELATING TO ACCESS TO QUOTATION INFORMATION

B1. What types of customers, if any, who cannot trade on interdealer screens should have access to such information? In your answer, please be specific concerning the type of customer and consequences for the market.

Although the perception exists that market information appearing on brokers' screens is unavailable to anyone other than primary and aspiring dealers, this is not the case. For example, today Telerate and Quotron provide information from one of the interdealer brokers as well as from several dealers, thereby making available the desired investment information to a broad universe of market participants. The bid and ask information currently available is useful to smaller investors as well as to large market

JAN 27 1987

makers because the customer base of the retail broker includes small as well as large government securities purchasers and sellers. Moreover, other information services such as Reuters, Knight-Ridder, Market Master, and Security Pacific Automated Trading System also provide market information. In addition, on an increasingly frequent basis, large dealers in government securities have begun to extend their screen systems to their own customers, thus further enhancing the competitive environment.

B2. What would be the benefits and costs of making information from interdealer brokers available to parties without trading access? Would interdealer brokers have the legal right to sell or divulge such information? If so, how should the dissemination costs be paid?

Over the years, pricing and trading information has become more widely distributed. Utilizing the information contained within the GAO's final study, the Treasury Department may decide that public dissemination of the information holds the potential of expanding the universe of market participants, thereby increasing competition for securities, with a concomitant decrease in pricing. This trend, of course, would add depth to the market.

JAN 27 1987

On the other hand, some brokers suggest that the usefulness of the information disseminated may well depend upoh whether the information provided was executed trade information or bid and offer information. Executed trade information may prove helpful to dealers and investors as it would provide insights to market trends and volumes.

Bid and offer information, some brokers maintain, may mislead dealers and investors because these prices would not be available to them but only to large volume market participants. The costs of such a system may be increased inefficiency, increased cost of government securities transactions, and increased financial risks of such transactions. This impedes market liquidity.

The question of the legal right to sell or divulge price quotes is subject to debate among market participants. Some contend that the information should be sold and paid for in the same manner that various exchanges currently sell their information. Others contend that the bid and offer information belongs to the dealer and should not be released without the dealer's approval.

B3. Would public dissemination of the information displayed on interdealer broker screens overcome a substantial portion of the concerns about limited trading access? Please explain.

JAN 27 1987

Today, dealers and investors, to a limited extent, do have access to both trading information and the ability to execute transactions by using the services of a retail broker. Despite the services available through the retail brokers, the GSBA believes that increasing the public's access to information displayed on interdealer broker screens would not totally satisfy those dealers/investors who have demonstrated a distinct desire to obtain direct trading access. Those seeking access want the capability of effectuating their trades at the most competitive prices and wish to avoid any market movements resulting from any time lag that would exist if the trade occurred outside the interdealer broker network.

B4. Do dealers who are able to view the interdealer screens have an advantage in other markets, such as futures or options exchanges, over participants in these markets who are limited to seeing the retail screens? If such an advantage exists, how is it manifested, how significant is it, and should it continue or be eliminated? Please explain.

This is a question best addressed by dealers. It may appear that a dealer with complete access to all trading information appearing on the brokers' screens would have an advantage over participants who do not have such access.

JAN 27 1987

However, the brokers do not have firsthand knowledge of their customers' trading strategies and therefore cannot state definitively whether such an advantage in fact exists. It is, however, believed that market information currently available is sufficient to assist dealers and investors to develop effective trading strategies in government securities as well as their derivative products.

B5. Is the information on market prices currently collected and published by the Federal Reserves useful? Please explain.

This information is a useful but limited tool for analyzing the market for U.S. Treasury issues. The value of the information is limited by the fact that it is available only after the close of the day and consists of representative markets as of mid-afternoon rather than the actual bid and offer quotations.

C. UTILITY OF BROKERING SERVICES AND QUOTATION PRACTICES

An examination of the practices of other capital markets for characteristics or procedures relevant to the government securities market must be undertaken with an

JAN 27 1987

awareness of the differences between the U.S. government securities market and all other markets. No other capital market -- including the U.S. equity or corporate debt market -- is marked by its ability to smoothly and efficiently handle transactions totaling billions of dollars with little price volatility and with very narrow spreads between the bid and the ask quotations. Thus, the issue of access to brokers' services must be considered in the context of the U.S. debt market's unmatched liquidity and efficiency.

The GSBA trusts that the foregoing responses will prove helpful to the General Accounting Office in its ongoing study of the nature of the current trading system in the secondary market for U.S. government securities. If the GSBA can be of additional assistance in connection with this effort, please feel free to call upon the undersigned.

Respectfully submitted,

Lawrence I. Fox
Counsel,
Government Securities Brokers Association

JAN 27 1987

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APPENDIX VII

COMMENTS SUBMITTED BY
RMJ SECURITIES CORPORATION

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January 23, 1987

FEDERAL EXPRESS

Mr. Craig A. Simmons
Senior Associate Director
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Room 3862
441 G Street, N.W.
Washington, D.C. 20548

Re: Response of RMJ Securities Corporation to GAO Request for Comment on the Nature of the Current Trading System in the Secondary Market for U.S. Government Securities
File No.: 233175

Dear Mr. Simmons:

The undersigned represents RMJ Securities Corporation ("RMJ"). This letter is to provide the GAO with RMJ's comments pursuant to the above-referenced request in 52 Fed. Reg. 220 et seq. (January 2, 1987).

RMJ is engaged primarily in the business of "blind" brokering of U.S. government and agency securities. RMJ is an interdealer broker, providing its services to approximately 53 primary and aspiring primary dealers recognized by the Federal

JAN 27 1987

Reserve Bank of New York ("FRBNY"). As a "blind" broker, RMJ provides an anonymous trading service for its customers, matching bids and offers for U.S. government and agency securities through its brokers with the assistance of a highly sophisticated network of computerized screens. RMJ's brokerage services facilitate the rapid, orderly and anonymous trading of such securities in a secondary market which is widely recognized as having unparalleled liquidity, depth and efficiency.

RMJ is also a member of the Government Securities Brokers Association, a national trade association representing U.S. government securities brokers, the members of which collectively account for approximately 90 percent of transactions effected through government securities brokers. The trade association has submitted its own comments in response to the GAO's request.

TRADING ACCESS

1. **How important is blind brokering for the efficiency and liquidity of the government securities market?**

RMJ believes that the current system of blind brokering in the U.S. government securities market has worked extremely well for more than twenty years. Due to the structure of blind brokering, the screen automated technology introduced to the market by RMJ and the other brokers, and the confidence placed

JAN 27 1987

in the brokers by their customers, the market moves rapidly to the best price and execution regardless of the size of the transaction. RMJ believes that the blind brokering system is an essential ingredient in the liquidity, depth and efficiency of the market.

2. What are the costs and benefits of the current system of limited access blind brokering? What alternative arrangements, if any, should be considered? How does their costs and benefits compare with those of the existing system?

To date, the costs of the current system have been minimal to the dealers, particularly considering the ever-increasing volume of securities which are traded in the system. The benefits are obvious as the U.S. government securities market is recognized as the most efficient and liquid in the world. In addition, the current system is responsible for the establishment of a market which insures both the integrity and financial responsibility of market participants.

As to possible alternatives, RMJ is unaware of any other system which would provide the same degree of liquidity, depth and efficiency that is the hallmark of the market today. Even assuming an alternative system which could insure the credit-worthiness and integrity of all market participants, it is likely that a significant reduction in the number of transactions effected through blind brokers would result in

JAN 21 1987

trading inefficiencies and price volatility which would in turn ultimately affect the depth of the market and the capacity to trade an ever-increasing volume of U.S. government and agency securities. RMJ believes that any such consequence would be contrary to the public's and the Treasury Department's interest in having a market mechanism to service the national debt and other government obligations.

3. Of the considerations influencing screen broker decisions on which firms should have access, which do you feel are relied on most heavily and which least heavily? Is this appropriate? Please explain.

Several considerations influence RMJ's decisions on access including: financial stability of the customer, trading qualifications of the customer's personnel, familiarity with the customer and its trading personnel (know your customer), and trading history and posture of the customer. As discussed below, the FRBNY's oversight and monitoring of primary and aspiring primary dealers has traditionally provided the screen brokers, including RMJ, with a system of insuring the stability and creditworthiness of their customers.

4. What are the consequences of current access practices for the liquidity and efficiency of the market and for various market participants? In your answer, please distinguish carefully between types of dealers and investors.

Current access practices focus primarily on the financial stability of the customer and the trading competence and

JAN 27 1987

integrity of the customer's management and personnel. The purpose of this focus is to acquire a degree of confidence that the customer will trade and will trade with a high degree of competence and integrity. It is this confidence between and among dealers and brokers that facilitates such active trading with minimal misunderstandings and errors. Indeed, it can hardly be disputed that current access practices are responsible, at least in part, for the growth and development of the market as it exists today.

Nonetheless, changes can be conceived to broaden access while insuring that the basic speed, integrity and depth of the market is not affected. RMJ believes that the key factor is to develop a mechanism for insuring that new participants are creditworthy and otherwise meet the criteria listed above, and that their entry into the market does not cause current market participants to abandon the screen brokers to execute their trades. Apart from its obvious self-interest, RMJ believes that if large dealers abandon the current system, the market as a whole will suffer in terms of costs per transaction and overall reliability.

5. What risks are associated with blind brokering? Who bears these risks? Do the risks necessarily increase when the numbers of dealers trading on the system increases? What alternatives exist to control these risks? Which, if any, of these alternatives provides an acceptable level of risk control at a reasonable cost?

JAN 21 1987

The risks associated with blind brokering are twofold:

1) The risk of a misunderstanding in price, issue or quantity between a broker/dealer on a given trade. This is resolved between the parties; and
2) The overnight interest expense risk on a failure to deliver a security before the close of business. This expense is borne by the party failing to make a delivery.

These risks would probably increase as the number of trading dealers increases, simply as a consequence of more involved parties. However, it should be noted that, given the size and depth of the current market, the incidence of fails is miniscule, and if an error condition occurs, market participants usually resolve the problem immediately by negotiation. If the current system were to change radically and access to screen brokerage expanded widely, it is also possible that the limited agent status of blind brokers could change such that they would be considered principals in their transactions. RMJ feels that that would in turn undoubtedly increase financial risk and trading costs.

6. For what reasons do you consider it acceptable or unacceptable for brokers to require new customers to first have a business relationship with the FRBNY as a primary dealer before it will consider the customer's application for access? To what extent, if any, does your answer depend on your perceptions of the FRBNY's business relationship with primary dealers? If it does, what aspects of that relationship are most important?

JAN 21 1987

At present, not all participants in the U.S. government securities market are regulated. As such, unlike the equity or other markets, there are no common or uniform methods for evaluating the financial stability or business of a market participant. The one regulatory quideline that has historically existed is the FRBNY; thus, the practice of looking to the FRBNY evolved in the absence of any other government oversight. However, RMJ recognizes that there no doubt exists acceptable potential customers which do not have a relationship with FRBNY.

The Government Securities Act of 1986 and the system of regulation contemplated thereunder may provide new, and perhaps more useful, guidelines of creditworthiness and responsibility. However, while RMJ would welcome expansion of the market to include new responsible customers, it believes that change and expansion of the market must be considered carefully so that current market participants are not driven away.

7. What would be the consequences if the list of dealers with trading access to interdealer screen brokers were to diverge significantly from the list of primary or aspiring primary dealers? Would brokers allowing expanded access lose business? If they did, would the loss of major market participants from the screen brokering system make it harder to sell the public debt or to conduct monetary policy? Would risks in the interdealer market increase significantly? To what extent might any cost of allowing such access be offset by any benefits from greater participation by other dealers in these systems?

JAN 27 1987

RMJ believes that the issue is not so much whether new customers have a relationship with the FRBNY like the primary dealers, but whether they would adversely affect the market as it is currently constituted. Moreover, growth itself could have an effect. If the list of dealers were to change significantly, several consequences could occur:

1) the cost of doing business could increase as the expenses of dealing with more parties would be added to the system;
2) spreads could come down if the added participants were more aggressive;
3) risks could increase if the added participants were not properly regulated;
4) as noted above, the status of brokers as agents only could change, thereby increasing costs and threatening the effectiveness of the current system; and
5) market information could become more widespread.

Historically, the primary dealers, the customer base of the blind brokers, have sought to insure the integrity of this highly successful market, and as such, have been most protective of access to broker screens. The major dealers have, in fact, organized a captive broker with the announced intention of reducing commissions and maintaining control on

access and market information. Individual dealers have also traditionally made it known that they may not transact trades through RMJ if it attempted to expand its customer base to include dealers not meeting their respective credit or trade practice criteria. Loss of major market participants could also affect the ability to sell public debt, but there is no evidence of this. Greater participation by other dealers could replace any reduction, but there is a delicate balance which must be struck between driving away current market participants and adding new ones.

8. Under what conditions, if any, should firms who are neither primary nor aspiring primary dealers but who specialize in certain segments of the Treasury, agency, or mortgage-backed securities markets be able to obtain trading access to the interdealer broker screens for segments of the market in which they specialize? Would greater availability of limited access arrangements for such dealers affect the overall depth and liquidity of these markets? Please explain.

If a dealer specializes in a particular segment of the market, is financially sound, makes markets, and trades with competence and integrity, it would be logical for that dealer to participate. If the safeguards are in place, the addition of such specialized dealers should enhance the depth and liquidity of the particular market segments in which they trade. This is obviously an area which should be addressed by the contemplated Treasury Department regulations.

JAN 27 1987

9. The Treasury Department must adopt rules for brokers and dealers, including rules for financial responsibility. Would you expect these rules, and the associated enforcement of them by the appropriate federal regulator, to affect access to interdealer broker trading systems? In answering these questions, what assumptions have you made about whether interdealer brokers are acting as agent or principal?

If the Treasury Department does adopt reporting and capital requirements for brokers and dealers, the rules could also address access to the market. Regardless of who has access to the market, the interdealer broker's function should remain the same, i.e., the interdealer broker shall continue to be: "an entity that acts exclusively as an agent on behalf of unidentified principals, who are regulated dealers, in the purchase and sale of government securities, and who have no customers as defined by the rules of the SEC or NASD, and who does not have or maintain any government securities in its proprietary account".*

10. Would development of a netting system for clearing and settling government security trades affect the risks faced by screen brokers and their customers? How, if at all, would you expect such developments to affect access to interdealer broker trading systems?

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* The quoted definition is derived from SEC Rule 15c3-1, which defines the role of a municipal bond brokers' broker, and has been urged upon the Treasury Department as a working definition for screen blind brokers by the Government Securities Brokers Association in connection with the proposed regulations on brokers' capital adequacy requirements.

JAN 27 1987

RMJ believes that a proper netting system would reduce the risk and expenses of both brokers and dealers in the settlement process. However, strict compliance, mandatory trade submission, proper participant fund procedures, and correct transaction adjustment payments must be required, or the risks to both brokers and dealers will increase. RMJ does not believe that such developments will significantly affect access.

11. How might actions designed to reduce daylight overdraft exposure now being considered by the Federal Reserve System affect your assessment of the blind brokering system and access to it?

RMJ does not believe these actions would affect the blind brokering system or access to it. However, unduly restrictive regulations on clearing banks or upon the time and volume of book entry transfers would have an adverse impact on all market participants.

ACCESS TO QUOTATION INFORMATION

1. What types of customers, if any, who cannot trade on interdealer screens should have access to such information? In your answer, please be specific concerning the type of customer and consequences for the market.

Currently, all investors have more access to the U.S. government securities markets than is commonly perceived. Telerate and Quotron, major distributors of market information, provide current market prices from several dealers as well as

JAN 27 1987

one of the interdealer brokers. In addition, most major firms provide prices through their own communications companies or outside distributors such as Blumberg, Reuters, Knight Ridder, and A.D.P. As to additional customers, RMJ believes, as noted above, that creditworthy and otherwise responsible dealers should have access, but expanded access should not be allowed to disrupt current market efficiency, liquidity, and depth.

2. What would be the benefits and costs of making information from interdealer brokers available to parties without trading access? Would interdealer brokers have the legal right to sell or divulge such information? If so, how should the dissemination costs be paid?

As the market changes, prices have become public to a much greater degree. As part of the current study of the market, the Treasury Department may decide that public dissemination of last trade information would be a positive step toward overcoming the concerns about limited trading access. This would put the U.S. government securities market in line with the equity markets. The last trade information could be sold to whomever wished to receive it in a manner similar to the various stock exchange ticker tapes.

RMJ believes that last trade information may be beneficial to dealers and other investors. Bid and offer information, however, may mislead dealers and investors since those prices,

JAN 27 1987

for purposes of actually executing trades, may not be available to them as they are to large volume market participants who have the ability to execute their trades rapidly.

As to the legal issue of whether interdealer brokers have the right to sell or divulge screen information, there are two schools of thought. However, it should be noted that one major retail broker has already been selling bid and offer information for several years.

3. Would public dissemination of the information displayed on interdealer broker screens overcome a substantial portion of the concerns about limited trading access? Please explain.

As an initial matter, it is worth noting that public dissemination of the live bid and offer information is not available in either the U.S. government securities market or other markets. Nor does RMJ believe that such public dissemination will necessarily overcome concerns about trading access because the ability to trade within the current system, as opposed to simply having the data generated by it, offers a dealer the prospect of rapid execution providing protection against market movements which could result from time lapses that exist in executing trades outside the current system.

4. Do dealers who are able to view the interdealer screens have an advantage in other markets, such as futures or options exchanges, over participants in these markets who are limited to seeing the retail screens? If such an advantage exists, how is it

JAN 27

manifested, how significant is it, and should it continue or be eliminated? Please explain.

RMJ believes that dealers who view the interdealer screens are perceived to have an advantage in other markets. As mentioned above, this may be more imagined than real since the retail screens are available. Indeed, if the dealers do have an advantage, it is not because they view the screens but probably because they are the "market makers". In any event, RMJ is not in a position to provide any firsthand comment on this question since it is not a dealer.

5. Is the information on market prices currently collected and published by the Federal Reserves useful? Please explain.

The information is useful but only to a limited extent since it encompasses only U.S. Treasury issues and because of its release time.

* * *

Naturally, RMJ will be happy to provide the GAO any additional information that might be helpful. Please do not hesitate to contact the undersigned if that is so.

Respectfully submitted,

John F. Cambria

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APPENDIX VIII

COMMENTS SUBMITTED BY FUNDAMENTAL BROKERS INSTITUTIONAL ASSOCIATES

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FUNDAMENTAL BROKERS INSTITUTIONAL ASSOCIATES.
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Mr. Craig A. Simmons
Senior Associate Director
General Government Division
General Accounting Office
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Washington, D.C. 20548

JANUARY 23, 1987

Dear Mr. Simmons:

This letter is to provide the General Accounting Office ("GAO") with comments by Fundamental Brokers pursuant to the request for comments in 52 fed. reg. 220 et seq. (January 2, 1987). Comments concern the nature of the current trading practices in the secondary market for U.S. government securities.

Fundamental Brokers is pleased to participate in the GAO study and to provide specific comments to each of the questions posed in your request. In summary, it is our belief that the present mechanisms for trading government securities in the secondary market have worked extremely well, providing all participants with markets of unparalleled liquidity, efficiency and safety. Access to information and trading in the interdealer and retail brokers markets has expanded significantly over the years to meet the needs of an expanding market place.

It is our expectation that this evolutionary process should and will continue. However, great care must be exercised in the process to ensure the preservation of a safe, liquid and efficient market mechanism as indicated in the responses to specific questions. Dramatic changes in the system affecting confidence in the integrity of the interdealer brokers market could have a devastating effect on liquidity and efficiency if existing dealer clients become less willing to participate.

We hope the following comments will be helpful to the GAO and other agencies of the Government in their evaluation of this important segment of the government securities market.

TRADING ACCESS

1. How important is blind brokering for the efficiency and liquidity of the government securities market?

Fundamental Brokers

We believe that blind brokering is vital to the efficient operation and liquidity of the government securities market. The existence of blind brokering provides anonymity to a group of dealer/market-maker/distributor's ("Dealers") who are substantially responsible for the underwriting of new US debt securities, providing a vechicle for FRBNY open market activity, and the redistribution of existing US debt instruments in the secondary market. It should be borne in mind that such dealers compete with one another in the purchase and sale of those government securities. If blind brokering did not exist, each dealer could identify its competitor's strategies. Possession of such specific knowledge on a trader by trader basis would have severe repercussions with repect to the competitive functioning of the market and would be inconsistent with the overall national policy of promoting and preserving competition. As the Supreme Court decided in United States v. Container Corp. of America, 393 U.S. 333 (1969), the exchange of such competitive price data of specifically identified competitors would likely raise serious problems under the antitrust laws.

Anonymity permits these Dealers to trade large blocks without revealing strategies. It also removes from the pricing mechanism, the effects of competitor knowledge of an individual Dealer's strategy or position. This permits the Dealers to trade freely, without hesitation in respect of what effect their trading patterns may have on prices.

2. What are the costs and benefits of the current system of limited access blind brokering? What alternative arrangments, if any, should be considered? How do their costs and benefits compare with those of the existing system?

The question assumes that there is a single "system of limited access" brokering to which Fundamental Brokers and competing brokers subscribe. Contrary to that assumption we know that another broker uses a different approach than we and all remaining brokers are free to decide for themselves whether to provide services to particular customers, whether to limit their customer base or whether to service a broader selection of customers. We believe that brokers are like any other business and that each has the right to decide for itself the customers with which it will deal. Fundamental Brokers chooses its customers independently and without consultation with any other broker. We make our choice of customers on our own perception of our business interests.

The principal benefits of limited access blind brokering are two-fold. First and foremost, the system is designed to protect the integrity of the market by limiting access based upon creditworthiness (utilizing FRBNY designation). Second,

participants have felt that a limitation based upon performance by new dealers as market makers contributes to the willingness of existing Dealers to continue to perform a market making function.

We base our selection of customers on the two objective criteria of creditworthiness and participation in the market as determined by the FRBNY. We deal with all and any firms which meet these standards on a non-discriminatory basis. Considering the huge amount of trading and the risks involved if a Dealer were to default, we are convinced that these standards are sensible ones from the perspective of our own business.

By permitting anonymous trading among participants, our method of doing business provides rapid dissemination of information regarding price and size among participants; it promotes a competitive pricing and commission structure.

On the other side, the market operates with the usual costs of any competitive market in which rival firms compete for the patronage of customers. We each employ brokers, utilize screens and settle accounts. To that extent there is duplication. However, such competition has resulted in increased availability of services for customers and lower commission costs. Since there are no entry barriers, new brokers can enter the business and provide brokerage services to other dealers who are not presently served because they either fail to meet credit requirements or engage only in limited types of trading.

It is possible to consider a variety of alternative arrangements with varying degrees of access or perhaps margin functions to protect the integrity of the system, but it is difficult to predict the effect of such changes on the liquidity and efficiency of the market.

3. Of the considerations influencing screen broker decisions on which firms should have access, which do you feel are relied on most heavily and which least heavily? Is this appropriate? Please explain.

In respect of screen brokers' decisions as to access, we can speak only for our organization. We rely heavily on our independent assessment of the economic consequence to our own firm of expanding or contracting access. Credit requirements are vital in a blind brokering system and we rely upon the designation by the FRBNY of firms as primary or aspiring primary dealers as a means of assuring the quality of participants. This approval also meets the critical need to satisfy the credit requirements of our customers. If new participants are not acceptable counterparties to existing customers the system will not function.

Fundamental Brokers

Utilizing the Federal Reserve designations also provides a degree of assurance regarding the trading qualifications of prospective customers and their potential as accounts which will be profitable to service, since the Fed requires such firms to meet volume and quality standards.

4. What are the consequences of current access practices for the liquidity and efficiency of the market and for various market participants? In your answer, please distinguish carefully between types of dealers and investors.

Current access practices in the brokers market have clearly produced the most liquid and efficient market for securities in the world. The size of the market for government securities has expanded. New brokers have entered the field. Technological changes have been introduced which have made trading and settlement more efficient. The primary and aspiring primary dealers obtain maximum liquidity for themselves through the brokers network, which in turn has enabled them to provide liquid and efficient markets to their customers, including other dealers.

It is difficult to assess the impact on other dealers and investors. As noted, significantly different concepts of access might alter the participation of existing Dealers and diminish the degree of liquidity and efficiency in the brokers market and thus in the overall market for government securities.

Nonetheless, it is certainly possible that limited, well conceived changes could result in marginal increases in market liquidity and efficiency. The key element is the maintenance of confidence in the integrity of the blind brokering system.

5. What risks are associated with blind brokering? Who bears these risks? Do the risks necessarily increase when the number of dealers trading on the system increases? What alternatives exist to control these risks? Which, if any, of these alternatives provides an acceptable risk control at a reasonable cost?

The foremost risk in blind brokering is credit. The failure of a participant in such a system would be devastating to the integrity of the market. A major credit loss would impact heavily on all participants. Since brokers function as agents, the ultimate risk would be borne by those counterparties paired with the failing firm in individual transactions. Brokers

themselves bear the risk of errors occuring in the process of transacting business which can create temporary risk positions. Brokers also bear the risk of net fails to deliver which must be financed on an overnight basis.

Each of the above risks tend to rise in proportion to the volume of business. Increased credit risk, however, would be more likely to occur if credit standards were lowered, with less creditworthy participants admitted to brokers' systems.

One alternative to control risk would be the development of a margin system, especially for forward trades, including "when-issued" transactions. This cost of developing and operating individual systems of this type might well be prohibitive, but a central system of clearing government securities, might provide a vehicle for accomplishing this objective. Such a central system could also facilitate a greater degree of risk evaluation than is possible at present since the net exposure of each participant to all counterparties could be measured. Such a system operated by the FRBNY would probably be the most acceptable to all market participants.

6. For what reasons do you consider it acceptable or unacceptable for brokers to require new custmers to first have business relationships with the FRBNY as a primary dealer or to be an aspiring primary dealer before it will consider the customer's application for access? To what extent, if any, does your answer depend on your perceptions of the FRBNY's business relationship with primary dealers? If it does, what aspects of that relationship are most important?

A business relationship with the FRBNY as primary dealer indicates a willingness of the FRBNY to deal directly with the dealer, which in turn implies a high level of creditworthiness. A relationship as a primary or aspiring primary dealer also indicates a certain minimum level of reporting and monitoring by the FRBNY. Supplemented with adequate internal credit review procedures by interdealer brokers, the criteria of having a business relationship with FRBNY is acceptable, appropriate and adequate. Different brokers may reach different conclusions and some may be prepared to run greater risks or to provide brokerage services to different clients. At least one broker appears to have selected this option. From our viewpoint we believe that it makes good business sense to insist on sound credit and evidence of market participation in selecting our customer base.

Interdealer brokers came into existence to provide a service for which dealers who actively traded government securities were willing to pay. As a service provider the broker has no market power since the dealer can select any broker, can trade directly with other dealers without using any broker, or can organize its own brokerage facility. This is not to say that well conceived

alternatives might not be devised to accomplish the required objectives.

7. What would be the consequences if the list of dealers with trading access to interdealer screen brokers were to diverge significantly from the list of primary or aspiring primary dealers? Would brokers allowing expanded access lose business? If they did, would the loss of major market participants from the screen brokering system make it harder to sell the public debt or to conduct monetary policy. Would risks in the interdealer market increase significantly ? To what extent might any cost of allowing such access be offset by any benefits from greater participation by other dealers in these systems?

It is difficult to evaluate the impact of changes in the list of Dealers with trading access to interdealer screen brokers. A significant change in access by brokers would very likely result in a diminishment of business from existing customers, based upon the existing customers evaluation of credit risks and also upon their assessment of the competitive threat that brokers would pose to the Dealers by providing services to the Dealers' own customers. If major Dealer participants severely curtailed their use of interdealer brokers, liquidity in the market would decline, and it would indeed become more difficult to market the public debt and conduct monetary policy.

Risks in the interdealer market could increase significantly if changes in access were to permit a serious reduction in credit standards.

The consequences of a more limited change in access to interdealer screens, however may not be as great as some believe. The most serious problem of broader access is the creditworthiness question. In an environment of anonymous trading, creditworthiness can not be questionable. The problem may be resolved by any one of or some combination of the following:

a) revised settlement process (CNS) to reduce risks in clearance

b) participant funds (deposits), or margin requirements to "insure" the group of participants as a group against disruptions caused by any one member

c) On-going stringent net capital requirements

Greater dealer participation may result in broader distribution channels which might enhance liquidity and efficiency.

Fundamental Brokers

8. Under what conditions, if any, should firms who are neither primary nor aspiring primary dealers but who specialize in certain segments of the Treasury, agency, or mortgage-backed securities markets, be able to obtain trading access to the interdealer broker screens for segments of the market in which they specialize? Would greater availability of limited access arrangements for such dealers affect the overall depth and liquidity of these markets? Please explain.

While the question of developing appropriate and equitable conditions for access to brokers trading facilities become more difficult when one departs from the clear objective criteria currently used, a limited expansion of access for firms specializing in certain segments of the market should be possible. Significant dealer market participants meeting the same type of credit standards as the FRBNY requires for primary dealers could be more acceptable to existing participants as anonymous counterparties if they also undertake similar responsibilities of market making and distribution. While setting such terms and conditions would be more difficult without a third party evaluation (FRBNY in the present system); such an expansion of access to specialized dealers would likely add to the overall depth and liquidity of the market.

9. The Treasury Department must adopt rules for brokers and dealers, including rules for financial responsibility. Would you expect these rules, and the associated enforcement of them by the appropriate federal regulator, to affect access to interdealer broker trading systems? In answering these questions, what assumptions have you made about whether interdealer brokers are acting as agent or principal?

We do not expect the Treasury Department's rules of financial responsibility to have a major effect on trading systems.

Principally, we do not believe that any rules adopted would be restrictive enough to meet these market participants' needs unless such rules highly segmented the market. We believe Treasury's rules will be broad and all inclusive so as to be applicable all dealer market participants.

10. Would development of a netting system for clearing and settling government security trades affect the risks faced by

screen brokers and their customers? How if at all, would you expect such developments to affect access to interdealer broker trading system?

The development of a well designed netting system would significantly reduce both the risks and the costs of the securities settlement process given the following criteria:

a) mandated trade submissions

b) permissable partial delivery and defined maximum transaction clearance amounts

c) participants fund to protect against credit losses

d) careful monitoring of established credit limits

It is possible that such a system could affect access to brokers facilities by providing an alternative credit monitoring device to ensure the integrity of the market

11. How might actions designed to reduce daylight overdraft exposure now being considered by the Federal Reserve System, affect your assessment of the blind brokering system and access to it?

FRBNY actions to reduce daylight overdrafts are not likely, by themselves, to affect blind brokering systems as such. However, severe restrictions on the clearing banks or the imposition of overly restrictive time and volume limitations on the transfer of book entry securities could affect brokers as well as all other market participants.

ACCESS TO QUOTE INFORMATION

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1. What types of customers, if any, who cannot trade on interdealer screens should have access to such information? In your answer, please be specific concerning the type of customer and consequences for the market.

All customers should have access to at least some form of information regarding trading in government securities, such as last trade or representative markets. As a practical matter, one major retail broker already provides complete information through Telerate which can be obtained by anyone willing to

pay for the service. Live quotations are provided on this system which are in most instances comparable to that available on the other interdealer broker screens. Many dealers also provide similar quotations through in-house or media systems which are closely comparable to screen brokers.

2. What would be the benefits and costs of making information from interdealer brokers available to parties without trading access? Would interdealer brokers have the legal right to sell or divulge such information? If so, how should the dissemination costs be paid?

The benefits and costs may be academic since such information is already widely available as noted in the response to question # 1 above. While ownership of the quotations has been the subject of debate, this question has apparently not affected the willingness of primary dealers to provide quotations to the retail broker which now provides their price information to Telerate. Dealers, of course, could refrain from providing quotations to brokers which sold or published them without regard to legalities of ownership.

Dissemination costs could appropriately be paid in a variety of ways:

a) Users of such information may subscribe for the service. Such subscriptions may be tailored to the individual subscriber's needs, or within pre-established guidelines. Subscriptions could be paid in cash or, if such subscribers are also customers of the interdealer broker, it may be paid as part of the commission.

b) Information may be pooled by some pooling service and then disseminated. The pooling service would pay the interdealer broker and dealer community for the prices and charge what the market would bear for redistribution.

c) Last trade information or some other historical trade information may be provided to the exchanges or over the counter market (NASDAQ) for ticker dissemination. (These might be appropriate pooling sources similar to the live information discussed in b) above). Historical information might also be sold to the print media for hard copy publication.

3. Would public dissemination of the information displayed on interdealer broker screens overcome a substantial portion of

the concerns about limited trading access? Please explain.

Since quotations are already widely available, public dissemination of information displayed by other brokers would not likely overcome a substantial portion of the concerns over limited trading access.

4. Do dealers who are able to view the interdealer screens have an advantage in other markets, such as futures or option exchanges, over participants in these markets who are limited to seeing the retail screens? If such an advantage exists, how is it manifested, how significant is it, and should it continue or be eliminated? Please explain.

Presently, as mentioned there is one broker who disseminates such screen information broadly (over Telerate). Thus, any true advantage in the futures and options exchanges that would otherwise exist is at least partially mitigated by the existence fo this level of broad access.

5. Is the information on market prices currently collected and published by the Federal Reserve useful? Please explain.

The information on market prices collected and published by the FRBNY is useful as a general guide to market price levels for U.S. Treasury issues.

UTILITY

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1. In the government securities market, how do investors evaluate the terms and conditions on which their trades were executed?

Customers in the government securities market have access to a large number of dealers and brokers which compete vigorously for their business. Available quotations publicly displayed enable customers to monitor the competitiveness of the dealers with whom they transact business.

2. Discuss any aspects of brokers or dealer practices, not previously mentioned, that might be viewed as inconsistent with

the principles of investor protection and the maintenance of fair, honest, and efficient markets? What, if anything, should be done about these practices? What are the costs and benefits of any such actions?

We should all recognize that, with only a few isolated exceptions, this largely unregulated market has self-managed itself into the most liquid market in the world: operating fairly and honestly.

Broker and Dealer practices are generally consistent with the maintenance of fair, honest and efficient markets. Competition continues to grow among both brokers and Dealers in terms of number of participants and the quantity and quality of services provided.

3. Please describe any characteristics and practices of other markets that are appropriate benchmarks for evaluating the reasonableness of broker service and quotation availability in the government securities market.

The qualities of liquidity and efficiency of the government securities market are unparalleled. Quotation availability is greater in the government market than markets for other securities due in part to the more limited number and the homogeneity of government securities issues, which facilitates evaluation of relative quotations among and between various individual issues.

We appreciate the opportunity to express our firm's views on practices in the market for U.S. government securities. We will be happy to discuss in greater depth, any of the thoughts expressed above.

We remain

Sincerely yours,

FUNDAMENTAL BROKERS INSTITUTIONAL
ASSOCIATES, A LIMITED PARTNERSHIP

EDWARD J. GENG, President

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APPENDIX IX

COMMENTS SUBMITTED BY DISCOUNT CORPORATION

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Discount Corporation
of New York
58 Pine Street New York, N.Y. 10005

RALPH F. PETERS
CHAIRMAN OF THE BOARD

January 23, 1987

Mr. Craig A. Simmons
Senior Associate Director
General Government Division
U.S. General Accounting Office
Room 3862, 441 C Street, N.W.
Washington, DC 20548

Re: File #233175

Dear Sir:

Discount Corporation of New York ("Discount") is pleased to respond to the General Accounting Office's request for comments on the nature of the current trading system in the secondary market for U.S. government securities. Discount was organized in 1918 and has been recognized for a long time by the Federal Reserve Bank of New York as a primary dealer. As such, Discount is committed to bidding at each auction for U.S. Treasury securities, making a secondary market in them, and standing ready to transact with the Federal Reserve Bank of New York in its execution of domestic monetary policy. Like all primary dealers, Discount also reports its trading positions daily and its repurchase transactions weekly to the New York Fed and is otherwise subject to monitoring of its capital and trading positions by the New York Fed.

Importance of Blind Brokering

As Congress and the GAO have recognized, the U.S. government securities market is the largest, safest, most efficient, stable and liquid securities market in the world. That is not a fortuitous happening and cannot be dissociated from the market structure which has evolved under the aegis of the New York Fed as fiscal agent for the Treasury and as manager of the money supply. Familiarity with this structure is important in order to understand why anonymous trading, and therefore "blind brokering", are necessary for primary dealers to perform their functions and meet their public responsibilities.

The need for anonymity in dealer trading results from the commitments that primary dealers have both to submit bids in new issue auctions to the New York Fed as fiscal agent for the Treasury, and to make bids and offers in secondary market

JAN 27 1987

transactions to the New York Fed as implementor of central bank money supply decisions.

New Treasury issues are sold at sealed bid competitive auctions conducted by the New York Fed. From January 1 through December 31, 1986, $1.237 trillion of new issues (bonds, notes and bills) were sold at domestic auctions, averaging about 3 auctions per week. Each primary dealer is expected to submit bids in good faith in appropriate size at each auction. We understand that primary dealers have often accounted for more than 50 percent of the amount of new issues. This constant bidding base, in which primary dealers compete strenuously with each other, undoubtedly has a beneficial effect on the ultimate pricing of Treasury issues, no matter how many bids are submitted by non-primary dealers and others.

In order for primary dealers to be underwriting on the virtually continuous basis they do, commencing with when-issued trading one to two weeks prior to auction and continuing a week or more after auction to settlement, they must both be selling to customers and adjusting their positions by transacting with other dealers. Unlike an underwriting of a new corporate issue, which generally involves an organized underwriting syndicate headed by a syndicate manager who adjusts underwriting allotments among underwriters and selling dealers during a fixed-price offering, there is no syndicate for distributing any Treasury issue and no price stabilization procedures. Each underwriting primary dealer competes with every other primary dealer in reoffering prices and needs to be able to use the brokers' screens on an anonymous basis in order unilaterally to adjust underwriting allotments without the benefit of a syndicate manager and without the risk of making competing dealers, primary and secondary, aware of its trading activity and positions. If primary dealers lost their ability to adjust their trading positions anonymously, they would at the very least have to bid more conservatively at the Treasury auctions as to both the amount and the price for government securities, thus raising the cost to the Government of funding its debt.

As to money supply transactions, there is again no organized syndicate for the secondary market distribution (or accumulation). The New York Fed transacts with each primary dealer on a one-to-one basis and the dealer transacts, not only with customers but also anonymously with other dealers, in adjusting its position. This is necessary because the primary dealers are expected to make good faith quotations in size to the New York Fed for these transactions. Thus, anonymous trading through the brokers' screens is an essential mechanism for permitting national policy to be carried out in both primary distributions and secondary distributions (or accumulations) on a virtually continuous basis.

JAN 27 1987

As can be seen, rather than being a general "exchange", the government bond brokers provide a specialized mechanism for enabling primary dealers to carry out the responsibilities which they have accepted toward the New York Fed as fiscal agent for new issues and as implementor of Open Market Committee decisions. In order to perform these obligations towards the Government, primary dealers must make continuous markets to customers because, in the end, their customers are the other side of the primary dealers' intermediation. It is for this reason that such secondary market making is inseparable from the primary dealers' role as distributors of original issues and participants in money supply transactions. Anonymous trading by primary dealers on broker screens is an essential element of this mechanism.

Credit Considerations

A system of anonymous trading effectively requires either that the intermediary broker guarantee each counterparty's performance or that each dealer be confident of the creditworthiness of every other dealer which could be its counterparty -- every other dealer with access to the broker's screen. Given the size and volume of government securities transactions, it would be virtually impossible or prohibitively costly for brokers to accumulate enough capital to enable them to stand behind all dealer transactions effected by them for undisclosed principals. It is therefore critical that each dealer be confident at all times of the creditworthiness of every other dealer with access to the broker's screens.

A party's status as a primary dealer is a uniquely important credit consideration -- not because there are no non-primary dealers that may be equally creditworthy, but because, due to their business relationship with the New York Fed, primary dealers are constantly monitored by a government agency which has a business incentive to assure itself of their ongoing creditworthiness. Of course, registered broker-dealers and banks must demonstrate periodically that they comply with certain financial responsibility and capital adequacy requirements. However, their regulators do not have the manpower, or the business incentive, to monitor such compliance constantly. By contrast, the New York Fed often enters into transactions with the recognized dealers and so has a direct interest in assuring itself that the recognized dealer can meet its obligations to the New York Fed. To reach continuous judgments on the recognized dealer's capability to meet those obligations, the New York Fed obtains a precise and current awareness of the dealer's financial position, including other obligations which the dealer has.

This constant monitoring of total financial position is particularly important in the current environment. The gigantic size of the present government securities market, together with

JAN 27 1987

the volatility of interest rates in the 1980's, has led to an era of unprecedented earnings volatility. Huge trading losses have been reported from time to time in the past few years for well-established, and regulated, firms. The financial condition of a firm that reports on a quarterly basis could easily swing from sound to unsound during a fiscal quarter before its regulators even became aware of its problems. Because of its monitoring of daily reports and the knowledge that comes from itself being active in the market, the New York Fed can learn promptly of a primary dealer's problems and can inform the primary dealer that it has credit concerns about continuing to do business with the dealer. That is a powerful incentive for the dealer to adjust its affairs quickly. The efficiency and reliability of the system are best demonstrated by the fact that there has not been a single financial failure of a primary dealer.

From the perspectives both of their particular needs for "blind brokering" and of the monitoring of their operations by the New York Fed, the primary dealers are therefore the most logical candidates for anonymous trading through the brokers' screens.

Competitive Nature of the Government Securities Market

It is important to understand that any entity can become a primary dealer if it meets the New York Fed's publicized standards. As the New York Fed stated in requesting comments on its capital adequacy guidelines, "a primary dealer must be actively engaged in the distribution of Treasury securities among investors, have adequate capital, make continuous markets, and have a long-term commitment to the market". Recognition is granted after a period of observation by the New York Fed of the dealer's financial strength, its market making capability, its experience and integrity, and its ability and commitment to serve the government securities market.

The number of primary dealers has recently expanded to forty from thirty-five, and we understand that approximately another dozen are in the process of qualifying.

The primary dealers are intensely competitive with each other at auctions in the interdealer market and in the solicitation of customers. Spreads in the market are extremely narrow, given the size of transactions and the market's volatility.

JAN 27 1987

Consequences of Alternative Arrangements

Blind brokering with expanded access to brokers' screens

Broker as agent

In questions 7 through 9 in its request for comments concerning trading access, the General Accounting Office asks about the consequences of expanded trading access to the interdealer broker screens. Particularly if trading is to continue on an anonymous basis, expanded access of any sort raises the issue of monitoring creditworthiness, unless the broker stands behind the performance of each counterparty to each transaction. Any trading firm, whether a primary dealer, a specialist in certain segments of the market, a bank, a full-service broker-dealer, or a newly-regulated government securities dealer, is subject to the market volatility described above and therefore to the risk of a sudden decline in its financial condition. But no trading firms, other than the primary dealers and aspiring primary dealers, are subjected to daily reporting to and constant monitoring by, a government agency with a business interest in their creditworthiness. Since no such firm would be likely to provide its trading counterparties with such daily information or allow such monitoring by its competitors, its counterparties would not have the means to assure themselves of its ongoing creditworthiness. Instead, they might well have to respond to any adverse market rumor concerning another firm by instructing the brokers not to execute trades between them and such other firm. Such restrictions would complicate matters for the brokers, increase brokering costs and reduce the speed of transactions. If such restrictions became widespread, they could even compromise the anonymity of such trading.

Netting systems for clearing and settling government security trades, like the proposals designed to reduce daylight overdraft exposure, principally address the credit exposure of clearing banks and would not reduce the overall costs of a dealer's failure to other market participants. Such participants would still need a means of assuring themselves of each other participant's creditworthiness.

Broker as principal

If the brokers were to guarantee the performance of each counterparty or otherwise act as principal, the creditworthiness of other trading parties would become less important. However,

JAN 27 1987

the immense amount of capital that such brokers would have to have in order credibly to stand behind all the transactions executed through their screens effectively precludes this alternative.

"Semi-blind" brokering

Some have suggested that it might be possible to structure market transactions to be anonymous only until the terms of the trade are struck. The identity of the parties would then be revealed to each other before the transactions were effected, in much the way that foreign exchange trading is conducted. We are convinced that this would not work in the government securities market. Foreign exchange transactions are individually negotiated, and each is tailored to a particular set of circumstances. To introduce this system into the government securities market would necessarily slow down the pace (and increase the cost) of transactions, to the detriment of continuous market-making and liquidity. It would also be susceptible to significant abuse, with trades cancelled once information is conveyed and with information as to dealers' market positions disseminated orally among traders as transactions are completed and the counterparty's identity revealed.

In conclusion, the present system of "blind brokering" among primary dealers and aspiring primary dealers is necessary in order to enable them to perform their functions and meet their public responsibilities in both the primary and the secondary government securities markets, is logical both from a credit standpoint and from a consideration of the entities with greatest need for such a system, and is an important contributor to the efficiency, stability and liquidity of the U.S. government securities markets.

Sincerely yours,

RP/dl

JAN 27 1987

APPENDIX X

COMMENTS SUBMITTED BY THE PRIMARY DEALER COMMITTEE OF THE PUBLIC SECURITIES ASSOCIATION

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Public Securities Association
1000 Vermont Avenue, N.W.
Suite 800
Washington, D.C. 20005
202) 898-9390

PSA

January 22, 1987

VIA HAND DELIVERY

Mr. Craig A. Simmons
Senior Associate Director
General Government Division
General Accounting Office
Room 3862
441 G Street, N.W.
Washington, D.C. 20548

Re: File No. 233175

Dear Mr. Simmons:

The purpose of this letter is to provide comments to the General Accounting Office ("GAO"), by the Primary Dealers Committee of the Government and Federal Agency Securities Division of the Public Securities Association ("PSA"),[1] pursuant to the request for comments which appeared at 52 Fed. Reg. 220 et seq. (January 2, 1987). The comments concern, in general, the current trading system in the secondary market for U.S. government securities, and in particular, the issue of access to the services provided by interdealer screen brokers.[2] The position of the Primary

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1/ PSA is the national trade organization representing more than 300 banks, dealers and brokers who underwrite, trade and distribute U.S. government and federal agency securities, mortgage-backed securities and municipal securities. PSA's membership includes all 40 primary dealers in U.S. government securities, as recognized by the Federal Reserve Bank of New York, and all the nation's major dealers in mortgage-backed securities.

2/ Interdealer screen brokers execute trades in U. S. government securities between recognized market makers -- primary dealers and firms recognized by the New York Fed as aspiring primary dealers. Until the 1970s interdealer brokers and dealers relied almost

(Footnote 2 continued on next page)

JAN 28 1987

Dealers Committee, in brief, is that the current system of trading government securities in the secondary market should not be changed. The system's structure has evolved over many years, and it provides a safe and efficient mechanism to meet the needs of the Treasury, the Federal Reserve and the investing public.

Interdealer Brokers' Screens Are An Integral Part of The Primary Dealer Function

As a condition of achieving and maintaining primary dealer status,[3] each dealer is required to participate

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exclusively on telephone communications to do their trading. Telephone communications, however, were simply not fast enough for dealers to learn the quotes of all other dealers. In 1974, automated brokerage services were offered to primary dealers in U.S. government securities. This automated, electronic service was initiated in order to overcome the inefficiencies in dealer-to-dealer and broker-to-dealer telephone communications. Brokers providing this service are known as "screen brokers." Each primary dealer has video display screens in its office, provided by the brokers, showing the bid and offer prices of the dealers. A dealer interested in bidding or offering can telephone the interdealer screen broker to offer or accept a displayed quotation.

3/ The emergence of a list of primary dealers as a public document occurred in 1960 as an adjunct to efforts by the New York Fed to receive more information about trading volume from primary dealers. In 1960 the New York Fed initiated a program which required primary dealers to report their transaction volume by type of customer. Dealers were asked to report separately their transactions with other reporting dealers. The list of reporting dealers was distributed so that dealers could determine the identities of other reporting dealers, and could thus correctly categorize their transaction
(Footnote 3 continued on next page)

JAN 23 1987

continuously in the process of underwriting U.S. government securities. In order to do this, dealers must be continuously selling to customers and adjusting their positions by trading with other dealers. Because there is no organized underwriting syndicate to adjust underwriting allotments or to manage distribution of U.S. government securities, each primary dealer must compete with every other primary dealer in reoffering prices. In order to do this efficiently, primary dealers must use brokers' screens on an anonymous basis. This allows dealers to adjust underwriting allotments without the benefit of a syndicate manager and without divulging trading strategies to competing dealers.

Interdealer brokers provide a specialized mechanism to enable primary dealers to carry out their responsibilities to the New York Fed as fiscal agent for new issues. In order to fulfill this responsibility, primary dealers must make continuous markets to customers, because, in the end, it is these customers who are purchasing the securities which have been underwritten, in the first place, by primary dealers. The secondary market, therefore, cannot be separated from the primary dealers' role as distributors of original issues. There is a continuous and integral relationship between the primary and secondary markets. Anonymous trading on brokers' screens is an essential element in preserving this relationship.

Structure and Function of the Secondary Market in Government Securities

A very active and important part of the secondary trading of government securities takes place through brokers. The brokers display bid and offer quotes on video screens without identifying the firms which are sources for the quotes. A dealer, hitting a bid through a broker, does not know the identity of the party on the other side of the

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(Footnote 3 continued from previous page)
volume. The New York Fed continues to believe that transaction volume data categorized by type of counterparty is useful.

JAN 28 1987

trade. The dealer does know, however, that the other party is a primary or aspiring primary dealer. This is because seven government security brokers, accounting for the bulk of trading activity in the secondary market, generally limit access to their services. Access is restricted to the 40 primary dealers designated by the Federal Reserve Bank of New York, and those dealers who have declared their intention to become primary dealers.

The practice of limiting access to the services of these seven brokers originates with the brokers themselves; and is based on each brokers' own assessment of business and credit risks. It reflects a judgment by each broker that restricting screen access to primary or aspiring primary dealers will provide that broker's customers with a measure of assurance that the counterparty in a trade is financially responsible and capable of transacting business in the market. Moreover, each primary dealer or aspiring primary dealer who is a customer of an interdealer broker must make an independent determination about which interdealer broker or brokers will be provided with the particular bid and quote information which is shown to potential counterparties.

Anonymous Trading Using Brokers' Screens

Brokers' screens provide the means of facilitating anonymous trading. Anonymous trading enables primary dealers to fulfill their commitment to make continuous secondary markets in a manner that is both efficient and secure. It is efficient because brokers are committed to acting without disclosing the counterparties of a trade. It is also efficient because customers are provided rapid access to bid and offer prices supplied to the brokers. The limitation on access to these screens by primary and aspiring primary dealers, who are monitored closely by the New York Fed, provides necessary security to the trading system.

Without anonymity, dealers, both primary and non-primary, would be able to determine current positions of other dealers in particular issues, and would adjust their trading strategies accordingly. Given such a situation,

JAN 23 1987

dealers would not be able to bid in amounts and at prices that are reflected in the auctions and current market. If trading were not anonymous, and the positions of particular dealers in particular issues were known, pricing against those dealers would be measurably affected, and liquidity in the market would be reduced. Anonymity in trading, then, is vital to the maintenance of a liquid, efficient and secure market. Anonymity in trading can only take place where dealers are certain that their counterparties are responsible, and that they have a long-term commitment[4] to the entire market, in both good times and bad. Only by limiting broker screen access to primary and aspiring primary dealers can traders be assured of the credit worthiness and continuous market making ability of their counterparty.

Risks In Altering The Current Methods Of Trading Government Securities

If brokers were forced to permit other than primary or aspiring primary dealers to have access to their screens,[5] and if the current practice of anonymous trading or blind brokerage were discontinued, liquidity in the market would be substantially reduced. Without reasonable assurances

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4/ In issuing its proposed capital adequacy guidelines, the New York Fed has stated that: "A primary dealer must be actively engaged in the distribution of Treasury securities among investors, have adequate capital, make continuous markets, and have a long term commitment to the market."

5/ The law is very clear. It permits a party to deal with whomever it wishes so long as that decision is independent. See U.S. v. Colgate & Co., 250 U.S. 300 (1919), where the Court held that a unilateral refusal to deal without more, and "[i]n the absence of any purpose to create, or maintain a monopoly" is lawful under the Sherman Act. It is entirely consistent with this long-held legal position that individual brokers remain free to choose with whom they will or will not do business.

JAN 23 1987

concerning the integrity, responsibility and market making ability of a dealer's counterparty, blind brokerage would wither away and liquidity in the market would, as a result, be negatively affected. The reason for this is simply that if non-primary and non-aspiring primary dealers were permitted access to the brokers' screens, the utility of the screens would be measurably lessened.

The present system allows brokers instantaneously to display bids and offers for U.S. government securities via closed circuit display screens located in their customer's trading rooms. This system provides customers with cost efficient access to trading information. If the utility of the brokers screens were lessened by eliminating current restrictions and access to the screens, the costs both of trading and of funding the debt would increase. If primary dealers were to use brokers' screens less, trading efficiencies brought about by these screens would be lost; liquidity of the market would be compromised; and interest rates would be forced up.

Primary dealers will have little incentive to use brokers' screens if the quality and reliability of their trading counterparties cannot be assured. Primary dealers are not going to place their capital at risk in a market where they cannot be assured that their counterparty will be subject to the same rigorous requirements that they are subject to by the New York Fed. It is important to understand that the brokers' screens are an integral part of a highly efficient and competitive government securities market. Altering this mechanism may have unintended system-wide effects that could reduce the depth, breadth and liquidity of the market. It could also adversely affect the ability of primary dealers to perform their on-going market making functions which are vital to the financing of this nation's debt.

Conclusion

The decision about which firms have access to the individual brokers' wires is a decision made by the

JAN 23 1987

individual brokers, and is based on that brokers' own assessment of the business risks involved. This system has worked extremely well for many years. Blind brokerage and restricted access to brokers' wires does not, as some have said, reduce liquidity in the secondary market. Trading opportunities are freely available through brokers who extend their services both to non-primary dealers and to some large investors. More generally, trading opportunities are available through phone contacts among all dealers, and with their customers. The existence of this broad secondary market has made the U.S. government securities market one of the most liquid markets in the world. As such, it works well to distribute new issues of Treasury securities and to accommodate Federal Reserve open market operations.

Because of the highly complex and integrated nature of this market, changes that would eliminate blind brokerage or provide unlimited access to brokers' screens could pose real risks to the marketplace. These risks will force primary dealers to reduce the size of their trades; thereby lessening the market's efficiency, decreasing its liquidity and dramatically increasing the cost to the Federal Government in financing its debt. It is almost certain, as discussed above, that primary dealers would reduce their reliance on brokers screens, and revert to less efficient and more costly telephone trading if blind brokerage were eliminated, or if access restrictions to brokers' screens were lessened. The effect of primary dealers lessening their use of brokers' screens would again be to increase interest levels and force the Federal Government to pay more to fund its debt.

There is simply no reason for this to occur. Primary dealer status is open to any party that meets the rigorous but necessary standards set by the New York Fed. This is indicated by the fact that there are now 40 primary dealers, compared to 29 dealers ten years ago, 18 dealers, 20 years ago, and 10 dealers, 30 years ago. We understand that there may be more than a dozen additional dealers who are in the process of qualifying as primary dealers.

The government securities market is intensely competitive at all levels. Spreads in the market are extremely

JAN 23 1987

narrow, given the sizes of the transactions involved. It is a highly efficient and liquid market. This is not fortuitous. Efficiency and liquidity in the market cannot be disassociated from two of the most important aspects of the market's structure -- blind brokerage and restricted access to brokers' screens. Tampering with these features may have unintended and detrimental system-wide effects.

Chairman Volcker in a July 18, 1985 letter to Senator Garn has stated that:

> The existence of [a] broad secondary market has made the U.S. government securities market one of the most liquid markets in the world. As such, it works well to distribute new issues of Treasury securities and to accommodate Federal Reserve open market operations, and there is little reason to believe that changes to enlarge the blind trading activities would have significant effects on the interest cost of the federal debt. Moreover . . . such trading among parties without a high degree of financial responsibility would pose real risks to the marketplace.

We believe, therefore, that the current system should not be changed.

Sincerely,

E. Craig Coats, Jr.
Chairman, Primary
Dealers Committee

JAN 23 1987

APPENDIX XI

COMMENTS SUBMITTED BY
CHEMICAL BANK

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CHEMICALBANK

Capital Markets Group
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S. Waite Rawls III
Managing Director

January 22, 1987

VIA COURIER

Mr. Craig A. Simmons
Senior Associate Director
General Government Division
U.S. General Accounting Office
441 G. Street, N.W., Room 3862
Washington, D.C. 20548

Re: File #233175
Comments on Current Trading System
in U.S. Government Securities

Dear Mr. Simmons:

Chemical New York Corporation ("CNYC") appreciates the opportunity to provide comments to the General Accounting Office (the "GAO") concerning the nature of the current trading system in the secondary market for U.S. government securities. CNYC's comments are provided as part of a GAO study, mandated by the Government Securities Act of 1986 (Pub. L. 99-571) (the "Act"), that is to assess whether quotations for U.S. government securities and the services of U.S. government securities brokers are available on terms that are consistent with the public interest, the protection of investors, and the purposes of the Act.

As the GAO request for comments notes, in passing the Act, Congress recognized that the U.S. government securities market is the largest, safest, most efficient, stable and liquid securities market in the world. Given the extreme importance of this market to the nation, Congress specifically directed that any regulation should not impair the efficient operation of the market, increase the costs of financing the Federal debt or compromise the execution of monetary policy. As discussed below, CNYC firmly believes that the liquid, safe and efficient nature of the U.S. government securities market is a direct result of its existing structure and relationships and, therefore, should not be significantly altered.

CNYC's primary banking subsidiary, Chemical Bank, has long been designated a "primary dealer" by the Federal Reserve Bank of New York (the "FRBNY"). As one of forty primary dealers, Chemical Bank submits daily reports on its net positions to the FRBNY and is generally subject to the ongoing surveillance of the FRBNY. Although the FRBNY's specific requirements for primary dealer status are not available to the public, as noted in the GAO request for comments, all primary dealers are

"expected to be creditworthy and participate actively in Treasury auctions [and] demonstrate a long-term commitment to the market."

As a primary dealer, Chemical Bank has access to the secondary markets available through the seven screen brokers, often referred to as "interdealer brokers." As opposed to the services offered by the two "retail" brokers, the interdealer brokers operate as agent and restrict access to their services to the forty primary dealers and several other dealers aspiring to become primary dealers (herein collectively referred to as "primary dealers"). All transactions executed through the interdealer brokers are "blind" (i.e., the names of the counterparties are not disclosed).

As a preliminary matter, CNYC believes that the GAO can best assess the current structure of the U.S. government securities market, as well as any loss in efficiency or liquidity that may result from any change in the current structure, by examining the current structure and characteristics of other large financial markets. Approximately fifty percent (50%) of all transactions executed by Chemical Bank involving U.S. government securities are with the interdealer brokers, as agent for the other primary dealers.[1] The remaining fifty percent (50%) of all transactions executed by Chemical Bank involving U.S. government securities are with customers. These percentages are significant when compared to other large markets.

For example, in the New York foreign exchange market,[2] approximately ninety-three percent (93%) of all trades executed by foreign exchange dealers are with brokers or with other dealers, while only seven percent (7%) of the trades are entered into directly with customers. The high ratio of trades with brokers to total trades in the New York foreign exchange market, when compared to the ratio for the U.S. government securities market, illustrates quite graphically that the subject financial instrument reaches the customer (or end user) much faster and more

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1. As the GAO request for comments notes, these percentages are consistent with the averages for all primary dealers.

2. As noted above, CNYC believes that the GAO can best analyze the affect on liquidity and overall efficiency of any change in the current structure of the U.S. government securities market by closely examining other large financial markets. Since the foreign exchange market is the largest market in the world, it represents a useful model for this analysis, especially in light of the role played by brokers in the market. More specifically, in the foreign exchange market, access to the services offered by brokers is relatively open, since a broker will typically offer its services to any entity that the broker deems creditworthy. As in the case of the U.S. government securities interdealer brokers, foreign exchange brokers operate as agent. However, although trades are initially "blind," the names of the counterparties are disclosed once the bid is accepted. Significantly, at this time, either counterparty is permitted to "break" the trade because it does not want the credit risk of dealing with the other counterparty. When this scenario occurs, the broker may spend hours trying to "fix" the trade by interposing a chain of interconnected trades with other counterparties.

efficiently in the U.S. government securities market than in the New York foreign exchange market. As more fully discussed below, CNYC believes that the more efficient nature of the U.S. government securities market is a direct result of the current structure of such market, which includes restricted access to interdealer broker screens.

Trading Access

The GAO request for comments listed several questions regarding the manner in which the interdealer brokers currently operate and whether access to the interdealer brokers screens may be expanded without significantly altering the efficient, safe and liquid nature of the U.S. government securities market. As noted above, CNYC believes that the current attributes of the U.S. government securities market (i.e., efficient, safe and liquid) are a direct result of the limited access, blind brokering services offered by the interdealer brokers. More specifically, the current structure (1) permits large quantities of securities to be distributed quickly and efficiently, (2) fosters a willingness to execute large block trades, (3) streamlines the normal credit process and (4) provides the level of "comfort" necessary to trade with the interdealer brokers on a blind basis.

The first two benefits of the current structure listed above (i.e., the ability to move large quantities of securities quickly and in large blocks) are a direct result of the fact that all trades with interdealer brokers are "blind." In most financial markets, dealers are typically very interested in the current portfolio positions of their competitors. To the extent this information is ascertainable through the monitoring of brokerage activity, direct trades or otherwise, dealers often alter their willingness to purchase or sell specific securities, as well as enter into trades involving extraordinarily large blocks of particular issues. Since trades with the interdealer brokers are on a blind basis, these considerations do not factor into the decision to buy or sell particular securities. The net result is that dealers are willing to buy, accumulate and sell large blocks of particular securities, thus increasing the speed at which a large amount of securities will reach the customer or ultimate investor.

Several other factors present in the current structure of the U.S. government securities market also contribute to the speed and efficiency of the U.S. government securities market. First, primary dealers are required by the FRBNY to make a market in all outstanding Treasury issues. By limiting access to the interdealer broker screens to primary dealers, an efficient market is created whereby all participants are required to maintain a certain level of trading volume. Second, as discussed below, the current market structure permits primary dealers to establish the streamlined credit process necessary to support large volume trading.

The ability to accumulate and sell large blocks of U.S. government securities is the main reason primary dealers are able to quickly distribute the large quantities of new securities auctioned by the Treasury. To the extent the process is slowed because dealers are unwilling to trade large blocks, the entire distribution system will slow and become less efficient, thus resulting in increased costs to the Treasury. CNYC submits that any significant alteration of the blind brokerage system currently in place in the U.S. government securities market will necessarily result in such increased costs to the Treasury.

The last two benefits of the current structure listed above (i.e., a streamlined credit process and the high level of "comfort" present in the current structure) result from the nature of primary dealer status. As noted above, access to the interdealer screens is limited to those institutions designated by the FRBNY as primary dealers.[3] Such institutions report daily positions to the FRBNY and are subject to the general surveillance of the FRBNY. Despite protestations from the FRBNY regarding reliance on primary dealer status for credit purposes, Chemical Bank (like other primary dealers) does view primary dealer status as a necessary foundation for purposes of its credit analysis.

Although Chemical Bank subjects all institutions with which it trades securities (including primary dealers) to daily internal credit review, Chemical Bank would simply not be willing to transact business on a blind basis with interdealer brokers to the extent access to interdealer screens is available to institutions not reporting daily positions to the FRBNY. The reason for this position is simple -- as a bank, Chemical Bank is required by applicable state and federal regulations to conduct all activities in a manner consistent with safe and sound banking principals. To the extent Chemical Bank executed large block transactions on a blind basis with any dealer deemed creditworthy by a screen broker, Chemical Bank would clearly be violating its obligation to operate in a safe and sound manner

As noted above, the current structure and operation of the U.S. government securities market is dependent upon the ability of those dealers responsible for the primary distribution of Treasury securities to transact business with each other, through brokers, on a blind basis. Prudence and logic dictate that the number of institutions participating as principal in any system involving blind transactions must be limited to a small number of creditworthy institutions, which are monitored on a daily basis by a federal regulator.

CNYC believes this analysis illustrates that the efficient, safe and liquid nature of the U.S. government securities market is a direct result of the current system of limited access, blind brokerage, which permits (as noted above) large quantities of securities to be distributed quickly and efficiently in large blocks pursuant to streamlined credit processes. The current system is clearly dependent upon the existence of both blind transactions and limited access to the interdealer broker screens. The elimination of either characteristic will necessarily alter the manner in which the market currently operates (i.e., expanded access beyond primary dealers - will necessarily cause the elimination of blind brokerage).

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3. As the GAO request for comments notes, a small number of institutions have stated that they aspire to become primary dealers. As such, they are attempting to demonstrate their market making capabilities and other qualifications to the FRBNY. Since such institutions are complying with most of the reporting requirements of primary dealers, a few of these institutions have been granted access to certain interdealer screens. Based on an analysis of the creditworthiness of each such institution and its representation that it is reporting positions to the FRBNY, Chemical Bank has reached a determination as to whether it will continue transacting business with specific interdealer brokers.

To the extent the current system of blind brokerage is eliminated, two market characteristics will most likely develop. First, primary dealers will necessarily increase the number of transactions entered into directly. However, such a result would greatly reduce the efficiency and speed of the market, since primary dealers may have to make a substantial number of telephone calls to obtain the best price for a particular security rather than simply view a few screens. Additionally, the number of large block transactions executed will decrease as primary dealers focus on the positions and trading strategy of their competitors resulting in an increase in volatility. Second, the brokers will probably be forced to adopt procedures whereby the names of counterparties are revealed after an offer is accepted and either counterparty has the right to back-out of the trade. Again, the efficiency of the market will clearly suffer in terms of speed and volatility.

As described in footnote 2 above, these characteristics exist today in the New York foreign exchange market. Transactions between dealers (either directly or through brokers) represent a much higher percentage of total transactions in the market when compared to the U.S. government securities market. where one-half of all transactions by primary dealers are with customers. Since dealers executing trades through a broker have the right to back-out of a trade upon learning the name of the counterparty, it is often difficult to move a large position quickly. Credit concerns dictate this result. The efficiency of the market is further compromised by the fact that the size of the average trade is much smaller. Since dealers are often aware of their competitors positions, large block trades are rare. The net result of these characteristics is a much less efficient and more volatile market as compared to the current U.S. government securities market.

In sum, CNYC firmly believes that the efficient, safe and liquid nature of the U.S. government securities market is a direct result of the current system of limited access, blind brokerage. CNYC also believes that any significant alteration of the current system will clearly hamper the ability of the Treasury to issue securities at the lowest possible cost. Therefore, public policy is best served by avoiding any significant alteration of the current system.

Access to Quotation Information

The GAO has also solicited comments concerning the public availability of current price and last sale information in the U.S. government securities markets. As a general matter, Chemical Bank has found over the last several years that virtually all of its institutional customers possess detailed and accurate price information throughout the trading day. The source of this information is two-fold. First, as the GAO request for comments notes, this information is available on the retail broker screens, access to which may be purchased directly or through subscription to certain financial reporting services. Second, customers readily solicit and receive this information from primary dealers.

The current availability to the public of the information carried on the interdealer broker screens is reflected in the market price at which Treasury securities are available to the public. More specifically, little or no spread exists today between the prices on the bid side and sell side available to customers for short and medium term Treasury securities. The current economics of the secondary market reflect the availability of full

information. Thus, the ability of primary dealers to view the interdealer screens does not currently represent an advantage over other participants in the U.S. government securities or any other markets.

Since current price and last sale information is already available in the market, CNYC has no objection to any action seeking to make this information more readily available. However, CNYC believes that no such action is needed at this time.

Utility of Brokering Services and Quotation Practices

The GAO has also solicited comments concerning the general availability of quotations and whether best execution is obtained through the existing trading mechanisms. As noted above, the current economics of the secondary market (i.e., little or no spread for short and medium term Treasury securities) reflect the availability of full information concerning current price and last sale information, as well as the efficient nature of the secondary market.

In evaluating the terms and conditions on which their trades were executed, customers generally look to four factors: (1) price, (2) responsiveness, (3) speed of execution and (4) ability to move a large block of securities. With respect to the first two factors, the intense competition in the secondary market today has eliminated the spread between the bid side and the sell side for short and medium term Treasury securities, resulting in the availability of competitive prices from virtually all successful dealers in the secondary market. Given the extreme efficiency of the market with respect to pricing, dealers currently distinguish themselves to customers in other ways. As with any other products, responsiveness to the client is very important.

Of equal importance to the client, however, is the ability to execute a trade quickly and/or in large blocks. As noted in detail above, the extreme efficiency of the current market with respect to these factors (i.e., speed and size) is a direct result of the current structure of the U.S. government securities market. In this regard, CNYC submits that the current structure of the market does in fact yield best execution for its customers, when compared to any other financial market in the world today.

* * * * * * * * * * * * * * * * * * *

The Congress correctly recognized that the U.S. government securities market is the largest, safest, most efficient, stable and liquid securities market in the world. As noted above, CNYC firmly believes that the attributes of this market are a direct result of its current structure. Any significant alteration of the current system of limited access, blind brokerage will almost certainly result in a restructuring of the market along the lines which currently exist in the New York foreign exchange market. As illustrated above, CNYC submits that any such restructuring will be detrimental to both the Treasury's distribution effort and the customers, since the prices available in the market will reflect increased inefficiencies.

CNYC also believes that the current structure of the market supplies full and adequate information to the customer and yields best

execution of trades. However, CNYC has no objection to any suggestion by the GAO that customers be permitted to gain access to the information on the interdealer screens.

To the extent that GAO has any further questions or comments concerning this matter, please contact Michael G. Capatides (212-309-4131) or me (212-310-5233) at your earliest convenience.

Sincerely,

S Waite Rawls III

S. Waite Rawls III
Managing Director

SWR/MGC/dl/jdg
CMO GD Submsn

cc: Richard S. Simmons, Vice Chairman
Chemical New York Corporation

Fran Bermanzohn
Public Securities Association

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